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THE RESIDENCE OF TRUSTS FOR
CANADIAN INCOME TAX PURPOSES:

A Comparative Analysis and
Recommendations for Reform

By

Laura Penelope Ettinger



A thesis submitted to the Faculty of Graduate Studies and Research in partial
fulfillment of the requirements for the degree of Master of Laws

FACULTY OF LAW

Edmonton, Alberta
Fall 1993



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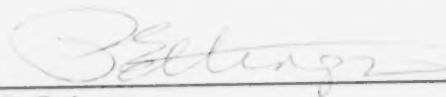
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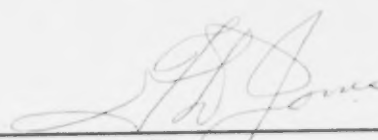
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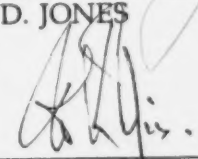
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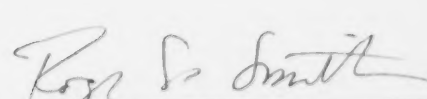
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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies and Research for acceptance, a thesis entitled "THE RESIDENCE OF TRUSTS FOR CANADIAN INCOME TAX PURPOSES: A Comparative Analysis and Recommendations for Reform" submitted by LAURA PENELOPE ETTINGER in partial fulfillment of the requirements for the degree of MASTERS OF LAW.



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ABSTRACT

Trusts are extremely useful devices for both estate planning and business purposes. Trusts may be established quickly and relatively inexpensively. They also afford a great deal of flexibility and privacy. It is unfortunate, therefore, that an important consideration with respect to the use of trusts has an element of uncertainty which remains unresolved. This important consideration is the residence of a trust for Canadian income tax purposes.

The Income Tax Act ("ITA") specifies that a reference to a trust shall be read as a reference to the trustee having ownership or control of the trust property. This has resulted in the commonly held view that the residence of a trust is to be equated with the residence of the trustee or a majority of the trustees. This "rule" has serious deficiencies which become most evident where there are multiple trustees resident in different jurisdictions. The solution to this problem is not found in the ITA, nor has it been resolved by the courts. Revenue Canada has published its own views of what the rules are or should be with respect to defining the residence of trusts. However, Revenue Canada's position cannot be said to have any legal foundation.

The purpose of this paper is to identify an appropriate test of trust residence for Canadian income tax purposes. The author considers the tests of residence adopted by three common law jurisdictions, namely the United Kingdom, Australia and the United States and examines the proposals contained in the report of the Royal Commission on Taxation. An extensive analysis of the various tests of residence is then undertaken. The analysis begins by determining who or what is the appropriate taxable entity and identifying the relevant general tax policy

considerations. The various tests of residence are then analyzed using the process recently adopted by the Supreme Court of Canada in a different, but analogous situation. This process analyzes jurisdiction to tax in terms of connecting factors.

Finally, the author identifies and discusses the features of the optimal test of trust residence and proposes an optimal test.

In order to set the stage for this extensive analysis of trust residence, the first part of the paper outlines in some detail the present Canadian taxation scheme relating to trusts and discusses the current status of the rules for determining trust residence in Canada.

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INTRODUCTION

Trusts are extremely useful devices for both estate planning and business purposes. Trusts may be established quickly and relatively inexpensively. They also afford a great deal of flexibility and privacy. It is unfortunate, therefore, that an important consideration with respect to the use of trusts has an element of uncertainty which remains unresolved. This important consideration is the residence of a trust for Canadian income tax purposes.

The primary basis for taxation of a person (which for income tax purposes includes an individual, a corporation and a trust) in Canada is residence. A person resident in Canada during a taxation year is liable for income tax on his or her world income. Consequently, the determination of residence is of utmost importance.

In the case of individuals there is a fairly well-developed body of statutory and judicial rules which provides adequate guidelines. Similarly, in the case of corporations, an extensive body of statutory judicial rules exists. With respect to trusts, however, the concept of residence is not defined in the Income Tax Act,¹ nor is the concept of residence easily applied to a trust.

A trust is not a legal entity, but instead an equitable obligation. A trust involves several elements: the settlor, the trustee, the beneficiary and the trust property itself. There is often more than one of each element and one entity can fulfill more than one role. Also, trustees, beneficiaries and settlors of inter vivos trusts may be corporations or other trusts. These features make it difficult to apply the concept of residence to a trust.

The ITA specifies that a reference to a trust shall be read as a reference to the trustee having ownership or control of the trust property. This has resulted in the commonly held view that the residence of a trust is to be equated with the residence of the trustee or a majority of the trustees. This "rule" has serious deficiencies which become most evident where there are multiple trustees resident in different jurisdictions. The solution to this problem is not found in the ITA, nor has it been resolved by the courts. Revenue Canada has published its own views of what the rules are or should be with respect to defining the residence of trusts. However, Revenue Canada's position cannot be said to have any legal foundation.

The purpose of this paper is to identify an appropriate test of trust residence for Canadian income tax purposes. In the course of doing so, this paper will first consider the tests of residence adopted by three common law jurisdictions, namely the United Kingdom, Australia and the United States. It will also examine the proposals contained in the report of the Royal

Commission on Taxation.² An extensive analysis of the various tests of residence will then be undertaken. This analysis will focus first on determining who or what is the appropriate taxable entity and identifying the relevant general tax policy considerations. An analysis of the various tests of residence will then be undertaken using the process recently adopted by the Supreme Court of Canada in a different, but analogous situation. This process analyzes jurisdiction to tax in terms of connecting factors.

Finally, this paper will identify and discuss the features of the optimal test of trust residence and ultimately attempt to formulate the optimal test.

In order to set the stage for this extensive analysis of trust residence, the first part of this paper will outline in some detail the present Canadian taxation scheme relating to trusts. In order to fully appreciate the importance of adequate rules to determine the residence of a trust, it is important to understand how trusts resident in Canada are treated for income tax purposes. Immediately following the discussion of the present Canadian tax scheme is a discussion of the current status of the rules for determining trust residence in Canada. It is similarly important to fully understand the inadequacy of the current state of these rules in order to fully appreciate the need for reform.

² Canada, Report of the Royal Commission on Taxation, 6 vols. (Ottawa: Queen's Printer, 1966).

2.

PRESENT CANADIAN TAXATION SCHEME RELATING TO TRUSTS ³

I. DEFINITION OF TRUST

Although there are many references to a trust in the ITA, the Act is not helpful for the purpose of determining whether or not a particular arrangement constitutes a trust. Resort must be made to the common law. The definition of a trust which is found in the ITA⁴ simply states that "trust" includes an inter vivos trust and a testamentary trust. An inter vivos trust is defined as "a trust other than a testamentary trust"⁵ and a testamentary trust as a trust or estate that arose upon and in consequence of the death of an individual, other than a trust created by a person other than an individual or a trust to which property has been contributed otherwise than by an individual on or after his death and as a consequence thereof.⁶

In addition to the distinction between an inter vivos trust and testamentary trust, there are many types of trusts to which there is direct reference in the ITA.⁷ This paper will deal only with personal trusts which

³ The legislative references in this part are current to December 31, 1992.

⁴ Paragraph 108(1)(j).

⁵ Paragraph 108(1)(f).

⁶ Paragraph 108(1)(i).

⁷ See for example, "personal trust" - subsection 248(1); "spouse trust" - subsections 70(6), 73, 104(4) and (5); "unit trust" - subsection 108(2); "mutual fund trust" - subsection 132(6); trusts governed by certain deferred income plans and as such exempt from tax under Part I of the ITA, such as an employees profit sharing plan - section 144, a registered

are defined in subsection 248(1) as either a testamentary trust or an inter vivos trust in which no beneficial interest was acquired for consideration payable either to the trust or to any person who has contributed any property to the trust. Where an individual (or two or more individuals each of whom was, at the time the trust was created, related to each of the other individuals) transfer property to and create an inter vivos trust, any beneficial interest acquired by the individual (or individuals) is deemed to have been acquired for no consideration.⁸

II. TAX TREATMENT OF TRUSTS

The general policy with respect to the taxation of trusts in Canada is that income and capital gains are to be taxed in the hands of the beneficiaries whenever practicable and where tax would not be unduly deferred. Otherwise, income and capital gains will be taxed in the trust.

Since a trust is not a legal entity the problem of enforcement of tax liability arises. In reference to this problem subsection 104(1) states that any reference to a trust or estate in the ITA shall be read as a reference to the trustee or executor, administrator, heir or other legal representative having ownership or control of the trust property.

supplementary unemployment benefits plan - section 145, a registered retirement savings plan - section 146, a deferred profit sharing plan - section 147 or a registered pension fund plan - section 146.3.

8 Subsection 248(1).

For income tax purposes, a trust is treated as an individual.⁹ This means the trust is taxed on income, as defined under the Act, earned both inside and outside of Canada including income from business, property and taxable capital gains deduction.¹⁰ A trust is not permitted to deduct personal tax credits allowed to other individual taxpayers. However, it may claim a deduction with respect to actual charitable donations or gifts to the Crown.¹¹ A trust is not entitled to the capital gains exemption.¹² However, proposed legislation will permit a personal trust to claim the personal residence exemption in certain circumstances.¹³

The taxable income of a testamentary trust is taxed at the same progressive rate as individuals which is set out in section 117. An inter vivos trust created after June 18, 1971, unless it meets the stringent criteria set out in subsection 122(2), is taxed at a flat rate of 29% (plus the relevant provincial rate).¹⁴

9 Subsection 104(2).

10 For the most part the basic taxation rules for trusts, as well as other individuals, are found in section 3. However, sections 104 to 108 provide additional special rules for trusts.

11 Subsection 122(1.1).

12 Subsections 110.6(2), (2.1) and (3).

13 Proposed amended paragraph 54(g) contained in Bill C-92 introduced on November 26, 1992.

14 Subsection 122(1).

In the situation of multiple trusts with the same settlor and substantially the same beneficiaries, the Minister may treat all the trusts as one trust for the purpose of taxation.¹⁵ This provision has been held to be inapplicable to the situation where the settlor created a trust for each of his four children.¹⁶

III. CALCULATION OF TAXABLE INCOME OF TRUSTS

A trust may deduct in computing its income for the taxation year any amount payable in the year to a beneficiary or that was included in computing the income of the beneficiary by virtue of subsection 105(2).¹⁷ Subsection 105(2) states that such part of an amount paid by a trust out of the income of the trust for the upkeep, maintenance, or taxes of or in respect of the property that, under the terms of the trust arrangement, is required to be maintained for the use of a tenant for life or a beneficiary as is reasonable under the circumstances shall be included in the income of the tenant for life or beneficiary for the taxation year for which it was paid. A trust may also deduct those amounts which are the subject of a preferred beneficiary election

15 Subsection 104(2).

16 Mitchell v. M.N.R. 56 D.T.C. 521 (T.A.B.).

17 Paragraph 104(6)(b). An amount payable to the beneficiary must be included in the beneficiary's income even though it may not have been received by him or her. The key is whether or not the beneficiary was entitled to enforce payment. See Johnson v. M.N.R. 58 D.T.C. 592 (T.A.B.).

and thus included in the income of a preferred beneficiary under subsection 104(14).¹⁸

There are exceptions to the deduction rule which relate to a spouse trust.¹⁹ A spouse trust may not deduct income payable to a beneficiary if that income arose as a result of the deemed disposition of property under subsections 104(4) or (5) on the death of the surviving spouse or if the income arose as a result of the deemed disposition of property under subsection 107(4) when property is distributed to a capital beneficiary other than the surviving spouse while the spouse is still alive. The income arising on such deemed disposition must be taxed in the spouse trust.

Another exception to the deduction rule is the amount payable to a designated beneficiary, as that expression applies for the purpose of section 210.3 (a designated beneficiary is essentially a non-resident) unless the trust is resident in Canada during the taxation year.²⁰

Where the trustee has a discretion with respect to payment, the income is considered to be payable to the beneficiary only if the beneficiary actually receives it or is entitled to enforce payment.²¹ Revenue Canada has

18 There is a detailed discussion of the preferred beneficiary election below.

19 Set out in paragraph 104(4)(a) and discussed in detail below.

20 Subsection 104(7).

21 Subsection 104(24). See also, No. 199 v. M.N.R. 54 D.T.C. 488 (T.A.B.); Wood v. M.N.R. 64 D.T.C. 780 (T.A.B.); Ansell Estate v. M.N.R. 66 D.T.C. 5508 (Ex. Ct.), aff'ing 62

taken the position that where a beneficiary could enforce payment by requiring that the trustee wind up the trust, any amounts not otherwise payable are not considered payable until the trustee actually causes the trust to be wound up.²² This position has no legal basis and, in the unlikely event it was challenged by a taxpayer, Revenue Canada would almost certainly abandon it.

Where a minor has a vested right to receive income, but it is not payable to him simply because he is a minor, then for the purposes of the ITA it is considered payable to him and he must take that amount into his income.²³ If the right to income is not regarded as vested then the income is taxed in the trust.²⁴ Generally a beneficiary does not have a vested interest if his or her share is to be accumulated and not paid until the beneficiary reaches a specific age.

Where the beneficiary's right to income is unenforceable during the first year of a testamentary trust solely for the reason of the common law rules relating to an executor's year (basically a one year grace period during which the administration of the estate may be completed), Revenue Canada has adopted the position that any income arising during that year may be

D.T.C. 545 (T.A.B.); Pichosky v. M.N.R. 64 D.T.C. 5105 (Ex. Ct.) and Jeremy Cole Trust et al. v. M.N.R. 81 D.T.C. 8 (T.R.B.).

22 See Interpretation Bulletin IT - 286R2, "Trusts - Amount Payable", dated April 8, 1988, paragraph 5.

23 Subsection 104(18).

24 Alger et al. v. M.N.R. 72 D.T.C. 1191 (T.R.B.).

taxed in the hands of the beneficiaries. If, however, even one beneficiary objects to such treatment, any income which is not payable during that first year will be taxed in the trust.²⁵

IV. INCOME OF THE BENEFICIARY

For the purposes of the ITA, the interest of a beneficiary is classified as either an "income interest" or a "capital interest". Paragraph 108(1)(e) defines an income interest to be the right of a beneficiary of a personal trust to receive all or any part of the income of the trust. The right may be immediate or future, absolute or contingent. The term "income of the trust" means income in the trust accounting sense,²⁶ which does not include accretions to capital, including capital gains. A "capital interest" is defined in paragraph 108(1)(c). It means the right of a beneficiary of a personal trust to receive any portion of the capital of the trust and any right of the beneficiary of a commercial trust. This distinction between income and capital interests is applicable to all trusts except unit trusts, the various deferred income trusts,²⁷ an inter vivos trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization or an RCA trust (a retirement compensation arrangement as defined in subsection 207.5(1)).²⁸

25 See IT - 286R2, supra, footnote 22.

26 Subsection 108(3).

27 See footnote 7 above.

28 Paragraph 108(1)(j).

For a trust resident in Canada (other than a deferred income trust described in subparagraph 108(1)(j)(ii)), the amount which is to be included in a beneficiary's income for the taxation year is that part of the trust's income which became payable in the year to the beneficiary.²⁹ Or, in the case of a trust governed by an employee benefit plan to which the beneficiary has contributed as an employer, the amount paid to the beneficiary.³⁰

Beginning with the 1988 taxation year, it is possible for the trust to designate all or part of the trust's income which is payable to a beneficiary as not so payable.³¹ The effect is that the income is taxed in the trust even though it has been received by the beneficiary. This provision creates the opportunity for some income splitting in certain situations. In the situation of a testamentary trust, the beneficiaries of which are taxed at a higher marginal rate than the trust, the benefit of the designation permitting all or part of the income payable to the beneficiaries to be taxed in the hands of the trust is clear. There is a slight possibility that this income splitting technique would be considered a contravention of the anti-avoidance provision contained in subsection 245(2). However, such is unlikely.

29 Subsection 104(13). See also Interpretation Bulletin IT-342R "Trusts - Income Payable to Beneficiaries", dated March 21, 1990.

30 Paragraph 104(13)(b).

31 Subsections 104(13.1) and (13.2).

The situations in which such income splitting is possible are limited. If the terms of a testamentary trust require it to distribute all of its income and the trust uses subsection 104(13.1) to designate that amount as not payable so it is taxed in the trust, the trust will not have any income with which to pay the tax liability without encroaching on capital. Also, if the trust uses the designation to assist one beneficiary (presumably one who is in a higher tax bracket than the trust), and not other beneficiaries, it is questionable whether or not the trustee has acted with an even hand as he or she is required to do.

The main advantage of subsections 104(13.1) and (13.2) is that they permit a trust to utilize losses carried over from previous years. The trustee simply designates sufficient income to be taxed in the trust to use up the losses.

In addition to subsection 104(13), subsection 105(1) provides that a taxpayer is to include in income the value of any benefit to him received during a taxation year from or under a trust.³² Excluded from this is a benefit with respect to property maintenance covered by subsection 105(2), the value of a benefit required to be included in the taxpayer's income under any other section and any benefit the value of which was deducted from the adjusted cost base of the taxpayer's interest in the trust under paragraph 53(2)(h), or would be so deducted if that section applied. Subsection 105(1) is included in

32 For definition of what constitutes a taxable benefit see Lyons v. M.N.R., 83 D.T.C. 113 (T.R.B.) and Cooper v. M.N.R., 88 D.T.C. 6525 (F.C.T.D.), rev'g 87 D.T.C. 194 (T.C.C.).

the Act in addition to subsection 104(13) because it is possible for a trust to apply its income to confer a benefit on a beneficiary for which there is no corresponding deduction for the trust under subsections 104(6) or (12). The exclusion of any benefit the value of which was deducted from the adjusted cost base of the taxpayer's interest in the trust under paragraph 53(2)(h) or would be so deducted if that section applied, is necessary so that the non-taxable portion of capital gains of a trust which are payable to a beneficiary do not form part of the beneficiary's income. This provision also operates to exclude any amount from the taxpayer's income that was payable to him under the trust, but has been designated under subsections 104(13.1) or (13.2) as taxable in the hands of the trust.

Subsection 108(5) provides that amounts included in a beneficiary's income are considered income from a property which is an interest in a trust and not from any other source unless specifically provided for in the Act.³³ Certain provisions do exist to permit a "flow through" of the nature of the income so that the beneficiary is in the same position as he or she would have been had he or she received the income directly. A "flow through" designation on the part of the trust is available with respect to taxable dividends,³⁴ taxable capital gains,³⁵ foreign income and tax paid,³⁶ pension income,³⁷ and death benefits.³⁸

33 Canada's treatment of trust income as a separate source of income is unique among most common law jurisdictions. Most jurisdictions preserve the character of the income as it passes through the trust. See Avery Jones, J.F. et al., "The Treatment of Trusts Under the OECD Model Convention - Part I" (1989) British Tax Rev. 41 at p. 51.

34 Subsection 104(19).

With respect to the "flow through" of taxable dividends, where a trust resident in Canada throughout a taxation year receives a taxable dividend³⁹ from a taxable Canadian corporation, the trust may designate that the amount considered paid or payable to a Canadian resident beneficiary be deemed to consist of the taxable dividend. Consequently the taxable dividend is deemed to have been received by the beneficiary rather than the trust for all purposes of the Act, including the dividend tax credit provisions.⁴⁰ If the beneficiary happens to be a corporation, then the concept of tax free intercorporate dividends applies and, if the dividend is received on a taxable preferred share, Part IV.1 may be applicable.⁴¹

With respect to the "flow through" of taxable capital gains, a trust resident in Canada throughout the taxation year may designate a part of any amount included in the income of a beneficiary under subsections 104(13), (14) or section 105 as a distribution to the beneficiary of net taxable

35 Subsection 104(21).

36 Subsection 104(22).

37 Subsection 104(27).

38 Subsection 104(28).

39 Taxable dividends are defined in paragraph 89(1)(j).

40 Sections 82 and 121.

41 Sections 82 and 112. For further details see Interpretation Bulletin IT-372R, "Trusts - Flow Through of Taxable Dividends and Interest to a Beneficiary", dated Oct. 25, 1985 and Interpretation Bulletin IT-524, "Flow-Through of Taxable Dividends to a Beneficiary - After 1987", dated March 16, 1990.

capital gains realized by the trust.⁴² The beneficiary must be resident in Canada during the year unless the trust is a mutual fund trust. Once the designation is made the amount is deemed to be the taxable gain of the beneficiary and he or she may offset same with any available allowable capital losses.

The amount of the beneficiary's capital gain which is eligible for the capital gains exemption under subsection 110.6(2) is calculated according to the provisions of subsection 104(21.2). The section is similar to section 110.6 which limits the capital gains exemption available to individuals claiming losses. The purpose of subsection 104(21.2) is to ensure that the beneficiary of a trust is treated in the same manner as if he or she earned the capital gains personally rather than such being flowed through the trust. First, the trust's eligible capital gains for the year must be calculated.⁴³ The trust must then designate to each beneficiary the proportion of the trust's eligible taxable gains for the year that the amount designated to the beneficiary is of the trust's net capital gains is for the year. The calculation is in three parts⁴⁴ to take into account the difference in lifetime capital gains exemptions for disposition of different types of property.⁴⁵ In most instances

42 Net taxable gains are defined in subsection 104(21.3) as taxable gains minus losses and carried forward losses.

43 Eligible capital gains are defined in paragraph 108(1)(d.2).

44 Subparagraphs 104(21.2)(b)(i) - (iii).

45 See subsection 110.6(2) for the exemption relating to qualified farm property, subsection 110.6(2.1) for qualified small business corporation shares and subsection 110.6(3) for other capital property.

the amount calculated to be eligible for the capital gains exemption will be the same as the amount designated to the beneficiary by the trust under subsection 104(21). There will be a difference, however, if the trust has utilized allowable business losses which reduce the capital gains eligible for the exemption.⁴⁶

The flow through of foreign income and tax paid is straight forward. Where a Canadian resident trust earns income from foreign sources and pays foreign tax, it may allocate the foreign income and taxes (less amounts that are permitted to be deducted under subsections 20(11) and (12)) to one or more beneficiaries. For the purposes of the ITA, the beneficiary is then deemed to have earned the foreign income and paid the foreign tax, if any.⁴⁷

With respect to the "flow through" of pension benefits, where a trust resident in Canada receives superannuation and pension benefits,⁴⁸ the trust may designate that they were received by a beneficiary where it is reasonable to consider that these amounts were part of the amounts included in the income of the beneficiary under subsection 104(13).⁴⁹ The benefits are

46 For further details see Interpretation Bulletin IT-381R2, "Deduction of Amounts Paid or Payable to Beneficiaries and Flow-through of Taxable Capital Gains to Beneficiaries", dated Nov. 29, 1991.

47 For further details see Interpretation Bulletin IT-201R, "Foreign Tax Credit - Trusts and Beneficiaries", dated Sept. 4, 1984.

48 As described in subparagraph 56(1)(a)(i).

49 Subsection 104(27).

then treated as having been received by beneficiary and are not included in the income of the trust. The beneficiary is then entitled to roll over all or part of the amount to a registered pension plan or an RRSP.⁵⁰ In addition, if the beneficiary is the spouse of the person whose death gave rise to the testamentary trust, the beneficiary may take advantage of the pension income tax credit found in subsection 118(3).

Finally, where a testamentary trust receives an amount upon or after the death of an employee in recognition of his or her service or employment, and the same may reasonably be considered to be included in the amount paid or payable to a particular beneficiary during a taxation year, such amount is deemed to not be received by the trust, but received directly by the beneficiary.⁵¹

V. DISPOSITION OF A BENEFICIARY'S INTEREST IN A TRUST

A. Disposition of an Income Interest

It is possible for a beneficiary to purchase an income interest in a personal trust without tainting its status as such, provided he or she does not contribute property to the trust or to a person who has made a contribution to the trust.⁵² For example, he or she may purchase the income interest from a

50 Paragraph 60(j).

51 Subsection 104(28).

52 See subsection 248(1) for the definition of a personal trust.

beneficiary who is not the settlor of the trust. Where a beneficiary must include an amount in his income under subsection 104(13), subsection 106(1) permits the beneficiary to deduct in computing his or her income any cost incurred in acquiring the income interest.

When a beneficiary disposes of an income interest in the trust he or she must include the amount of the proceeds of disposition in income.⁵³ Subsection 106(1) permits a deduction of the cost of acquiring the income interest from the proceeds of disposition. However, unless the interest was acquired from a former income beneficiary, the cost to the beneficiary is deemed to be nil.⁵⁴ After the deduction, if any, the remainder of the proceeds are taken into the beneficiary's income and are not treated as a capital gain.⁵⁵

If the beneficiary receives a distribution of property from the trust in satisfaction of his or her income interest in the trust, the trust is deemed to have disposed of the property at fair market value (thereby potentially creating a capital gain or loss for the trust),⁵⁶ and the beneficiary is deemed to have acquired the property at a cost equal to fair market value.⁵⁷

53 Paragraph 106(2)(a). See also, Interpretation Bulletin IT-385R 2, "Disposition of an Income Interest in a Trust", dated May 17, 1991.

54 Subsection 106(1.1).

55 Paragraph 106(2)(b).

56 Subsection 106(3).

57 Paragraph 106(2)(c).

B. Disposition of a Capital Interest

Special rules for determining the taxable capital gain or allowable capital loss that may arise on the disposition of a capital interest in a trust are provided in subsection 107(1). For the purpose of determining the taxable capital gain, if any, on the disposition of a capital interest in a personal trust, the adjusted cost base of the interest is deemed to be the greater of the adjusted cost base "otherwise determined" and the "cost amount" to the taxpayer of the capital interest in the trust.⁵⁸

There is an exception to this general rule upon the disposition of a capital interest in a non-resident inter vivos trust that was purchased by a taxpayer if this disposition does not entail the distribution by the trust of property to him or her in satisfaction of all or part of his or her capital interest. In such circumstances the adjusted cost base of the capital interest is determined without regard to the cost amount. Also, paragraph 53(2)(i) is a rather severe provision which applies in computing the adjusted cost base of a capital interest in a non-resident trust where that interest was purchased after 1971 from a non-resident and when 50% or more of the trust assets consisted of taxable Canadian property. In such a case, the taxpayer must deduct from the adjusted cost base of his interest in the trust an amount corresponding to proportionate share of the excess of the accrued capital gain on such properties owned by the trust.

58 Paragraph 107(1)(a).

The adjusted cost base "otherwise determined" will be the cost of that interest as adjusted pursuant to section 53. Paragraph 53(2)(h) states that where the capital interest in a personal trust was acquired for consideration, there shall be deducted from the adjusted cost base of that interest any amount paid to the taxpayer as a distribution or payment of capital otherwise than as proceeds of disposition of the interest or a part thereof.

The cost amount of a capital interest in a trust is defined in paragraph 108(1)(d). Essentially, the cost amount of a capital interest in a personal trust is the beneficiary's share of the net tax values of the capital property of the trust. However, this is subject to subsection 107(1.1) which states that the cost is deemed to be nil unless the taxpayer acquired the interest from a person who was a beneficiary immediately prior to the acquisition or where the capital interest was issued to the taxpayer by the trust and the taxpayer gave consideration equal to fair market value.

If a beneficiary has acquired his or her capital interest in the trust at a cost which is less than his or her share of the net tax value of the property of the trust, he or she will not realize a capital gain when he or she disposes of that interest unless the proceeds of disposition are greater than the beneficiary's share of the net tax value.⁵⁹ This does not apply, however, in calculating the allowable capital loss, if any, from the disposition of a capital

59 Paragraph 107(1)(a).

interest in a personal trust. In that situation the adjusted cost base of the interest will be as otherwise determined under the ITA.⁶⁰

Where any property of a personal or prescribed trust is distributed by the trust to a beneficiary in satisfaction of all or any part of his or her capital interest in the trust, there is basically a "roll over" to the beneficiary so no tax consequences are realized until the beneficiary disposes of the property.⁶¹ Essentially, the beneficiary takes the trust property at the trust's adjusted cost base.

One exception to the "roll-over" is a distribution by a spouse trust of capital property during the lifetime of the surviving spouse to someone other than the surviving spouse.⁶² A further exception is where the trust is a trust to which subsection 75(2) was applicable at any time.⁶³ Subsection 75(2) is an attribution provision which applies to "reversionary trusts". Such trusts are those in which the property is held on the condition that it or substituted property may revert to the person from whom the property was received or that person retains the right to determine, after the creation of the trust, the persons to whom the property will pass. In essence,

60 Paragraph 107(1)(b).

61 Subsection 107(2).

62 Subsection 107(4).

63 Subsection 107(4.1).

subsection 75(2) will apply where the contributor of property to a trust still retains significant control over that property.

If subsection 107(4.1) applies, the distribution will be governed by the rules in paragraphs 107(4)(d) through (f) (those which apply to a distribution by a spouse trust to someone other than the spouse during the spouse's lifetime) if the beneficiary was a person other than the contributor of property to the trust or the contributor's spouse and the contributor was still alive at the time the property was distributed.

It is important to note that subsection 107(4.1) will apply if subsection 75(2) was applicable to the trust at any time. Yet subsection 107(4.1) was added to the ITA in 1988. This can produce a somewhat unfair result in some situations. Take, for example, the situation of an inter vivos discretionary trust of which the settlor when the trust was first created was the sole trustee. Arguably, subsection 75(2) applied to the trust at that time because the settlor, as sole trustee, could determine to whom of the class of beneficiaries the trust property would pass. Accordingly, the trust was amended to add two additional trustees who had not contributed property and subsection 75(2) ceased to have application. Yet subsection 107(4.1) would still apply to deny the roll-over treatment of capital distributions during the settlor's lifetime.

VI. PREFERRED BENEFICIARY ELECTION

The accumulating income of a trust (as defined in paragraph 108(1)(a)) is the net income of the trust which was not payable during the year to beneficiaries. Many trusts provide for annual distributions of income, in the trust accounting sense, with any accretions to capital, including capital gains, to be accumulated. In such cases, the accumulating income for the purposes of the ITA will include net taxable capital gains for the year.

This accumulating income may be the subject of a preferred beneficiary election. Essentially, the trustee and preferred beneficiary jointly elect to have a portion of the accumulating income included in the income of the preferred beneficiary for that year⁶⁴ and deducted from the income of the trust for that year.⁶⁵ The effect is that the preferred beneficiary pays any applicable tax, even though he or she has not received the income. Once a preferred beneficiary election is made on a particular amount of income, that amount is not included in the income of the beneficiary who actually receives the amount in a later year. It has generally been considered that once a preferred beneficiary makes the joint election and takes the amount into his or her income, that amount may be paid tax free to any beneficiary, preferred or otherwise, at a later date and the preferred beneficiary has no right to claim it should be paid to him or her. This proposition has been questioned in

64 Subsection 104(14).

65 Subsection 104(12).

recent years and the issue remains unclear.⁶⁶ Although, Revenue Canada in IT-394R⁶⁷ seems to accept that the amount can be paid to someone other than the preferred beneficiary at a later date.

The term "preferred beneficiary", which is defined in paragraph 108(1)(g), includes every individual resident in Canada who is a beneficiary and who is,

- (a) the settlor of the trust,⁶⁸
- (b) the spouse or former spouse of the settlor, or
- (c) a child, grandchild or great grandchild of the settlor or spouse of any such person.

Both testamentary and inter vivos trusts may have preferred beneficiaries. However, the election is not available to unit trusts, deferred income trusts (such as pension fund trusts and RRSPs, etc.), related segregated fund trusts, an inter vivos trust deemed by subsection 143(1) to exist in respect

⁶⁶ See Sachs v. The Queen 80 D.T.C. 6291 (F.C.A.).

⁶⁷ Interpretation Bulletin IT-394R, "Preferred Beneficiary Election", dated July 14, 1989.

⁶⁸ "settlor" is defined in paragraph 108(1)(h). See also, Interpretation Bulletin IT-374, "Meaning of 'Settlor'", dated May 16, 1977.

of a congregation that is a constituent part of a religious organization or to RCA trusts.⁶⁹

In the case of a spouse trust, the income (including capital gains) arising as a result of the deemed disposition of property on the death of the surviving spouse⁷⁰ is excluded from accumulating income. Also, income which is held for a minor beneficiary, but is considered "payable" under subsection 104(18) is not considered "accumulating income" even though it is held in the trust because it is deductible under subsection 104(6) from the trust's income.

The amount which may be designated under a preferred beneficiary election to any one preferred beneficiary is limited to that preferred beneficiary's share of the accumulating income. This share is determined in accordance with the provisions of paragraphs 104(15)(a) to (d).

In the situation of an exclusive spouse trust⁷¹ where the surviving spouse is alive at the end of the taxation year, the surviving spouse is the only preferred beneficiary entitled to a share of the accumulating income. The share of any other preferred beneficiary is nil.⁷²

69 Paragraph 108(1)(j).

70 Deemed disposition under subsections 104(4), 104(5), 104(5.2) or 107(4).

71 Described in paragraph 104(4)(a).

72 Paragraph 104(15)(a).

Where the trustee has no discretionary power with respect to the entitlement of a class of beneficiaries, members of which are entitled to share equally in the income of the trust,⁷³ then the share of each preferred beneficiary in the class is calculated by dividing the portion of the accumulating income which may reasonably be regarded as earned for the benefit of that class by the number of beneficiaries in it (excluding registered charities).⁷⁴

In any other case where the trustee does not have a discretionary power with respect to a beneficiary's share, the share of a preferred beneficiary of accumulating income is the amount which may reasonably be regarded as having been earned for the benefit of that particular beneficiary.⁷⁵

In the situation of a trust, not described above, where each beneficiary's share of accumulating income is dependent upon the exercise or non-exercise of a discretionary power and each beneficiary is either a preferred beneficiary, would be a preferred beneficiary if he or she were a Canadian resident or is a registered charity, then different rules apply. In that situation, each preferred beneficiary's share is the amount prescribed by regulation to be his or her discretionary share for the year.⁷⁶ The relevant regulations are

73 It appears that "income" refers to income calculated according to the ITA rather than strictly income in the trust accounting sense.

74 Subparagraph 104(15)(b)(i).

75 Subparagraph 104(15)(b)(ii).

76 Paragraph 104(15)(c).

found in Part XXVIII, Subsections 2800(3) and (4). The regulations are long and involved. The main thrust is that where the settlor or his or her spouse is still alive and entitled to share in the accumulated income upon the exercise of some discretion, then their respective discretionary shares comprise the whole accumulating income. No other preferred beneficiary is entitled to share.⁷⁷ Where neither one is entitled or where one or both were entitled, but have since died, then the discretionary share of each preferred beneficiary is calculated by dividing the total accumulated income for the year by the number of preferred beneficiaries.⁷⁸

VII. SPOUSE TRUST

A settlor may create a special trust for his or her spouse (either a testamentary or inter vivos trust) which permits the settlor to defer any realization of capital gains or recapture of capital cost allowance on capital or depreciable property transferred to the trust until the surviving spouse dies.⁷⁹

The testator or settlor must be resident in Canada immediately before his or her death or transfer of property to the trust and the trust must be resident in Canada immediately after the property vests indefeasibly in it. The trust must provide that the testator or settlor's spouse is entitled to

77 Regulations 2800(3)(a) - (e).

78 Regulation 2800(3)(f).

79 Subsections 70(6) and 73(1).

receive all of the income of the trust⁸⁰ during his or her lifetime and that no person other than the surviving spouse is entitled to any income or capital of the trust while the surviving spouse is still alive.⁸¹ Finally, the property must vest indefeasibly in a testamentary spouse trust not later than 36 months after the testator's death.⁸²

A spouse trust will be considered to be created by a taxpayer's will if it is created by the terms of the will or by an order of the court in relation to the taxpayer's will pursuant to the relevant dependent's relief legislation.⁸³ Revenue Canada has also indicated in IT-305R3⁸⁴ that it will consider property to have been transferred to or acquired by a spouse or spouse trust where the transfer or acquisition resulted from a disclaimer, release or surrender by a beneficiary either under the will or on an intestacy. This allowance on the part of Revenue Canada effectively permits the creation of a spouse trust after the death of a spouse even though it may be contrary to the intent of the deceased spouse.

80 Subparagraphs 70(6)(b)(i) and 73(1)(c)(i). In this instance "income" means income calculated in accordance with trust law, in other words, without reference to the ITA.

81 Subparagraphs 70(6)(b)(ii) and 73(1)(c)(ii).

82 Paragraph 70(6)(b).

83 Subsection 70(6.2).

84 Interpretation Bulletin IT-305R3, "Establishment of Testamentary Spouse Trust", dated June 29, 1987.

If a trust would qualify as a testamentary spouse trust but for the provision for payment of testamentary debts of the testator,⁸⁵ a special procedure to "untaint" the trust is provided in subsection 70(7). Essentially, the legal representative of the deceased is allowed, within a specific time period, to remove from the spouse trust sufficient assets to cover the debts and the roll over applies to the remaining assets.

VIII. 21 YEAR DEEMED REALIZATION

Draft Legislation on the Income Taxation of Trusts was released by the Department of Finance on December 20, 1991. The Draft Legislation has since become part of Bill C-92 which was introduced in Parliament on November 26, 1992. The primary focus of the Draft Legislation was the 21 year deemed realization rule for trusts.

The existing rule, contained in subsections 104(4), (5) and (5.2), requires that a trust include in its income every 21 years the taxable portion of accrued gains on property held by it at the end of the 21 year period. For trusts, other than spouse trusts, the first disposition is deemed to take place 21 years after the later of January 1, 1972 and the day the trust was created. Therefore, for trusts created prior to 1972, the first deemed realization will take place on January 1, 1993. For spouse trusts, disposition is deemed to occur on the death of the spouse and every 21 years thereafter.

85 "testamentary debts" are defined in paragraph 70(8)(c).

The purpose of the rule is to prevent the indefinite deferral of the taxation of gains through the use of trusts. Generally, trustees will want to distribute the trust property to beneficiaries before the application of the 21 year rule and subsection 107(2) assists in this regard by providing for a tax-free disposition of property to beneficiaries in satisfaction of their capital interest.

There are certain situations where the trustees may wish to retain the property for more than 21 years. The proposed amendments will permit some flexibility in that application of the deemed realization rule may be deferred until there are no longer any exempt beneficiaries under the trust. For this purpose, an "exempt beneficiary" would include a spouse, child, sibling, parent, grandparent, niece or nephew of the "designated contributor". It should be noted that this group does not include grandchildren or other second generation relatives.

Also, often a trust which is subject to the rule will not have cash available to pay the tax arising from the deemed disposition. The proposed amendments would permit the trust to pay the tax, with applicable interest, in up to ten annual instalments.

Another problem addressed by the proposed amendments is that the existing rule may result in a deemed disposition of property used by a beneficiary as a principal residence. The proposed amendments would permit a personal trust to claim property as a principal residence where the property was used as such by a beneficiary.

Finally, it is currently possible to avoid the existing rule by transferring property on a tax-free basis from one trust to another trust which was created shortly before the first trust's deemed realization date. The proposed amendments would ensure that the recipient trust would have the same deemed realization date as the transferor trust. Also, a variation of the terms of the trust will not constitute a new trust for the purpose of the 21 year deemed disposition rule. This particular amendment is applicable with respect to variations occurring after February 11, 1991.

Proposed subsection 104(5.3) provides for the deferral of the 21 year deemed realization rule where the trust so elects in the prescribed manner and, at the end of the election year, there is an individual alive who is an "exempt beneficiary" under the trust. The deemed realization day is postponed to the day following the death of the last surviving exempt beneficiary. The election must be made in the prescribed form filed with Revenue Canada within six months after the end of the taxation year that would include a deemed realization day under the existing rule.

Where an election is made by a trust under subsection 104(5.3), a tax-free rollover to a beneficiary under subsection 107(2) may be made only to an individual who is an exempt beneficiary. Any other distribution of trust property after what would have been the deemed disposition day will be treated as a disposition at fair market value under subsection 107(2.1). Also, subparagraph 54(c)(v) (which provides that there is no disposition where

there is a change of legal ownership, but no change of beneficial ownership) will not apply to any disposition made by the trust after that date, unless the disposition is made to another trust which held no property immediately before the transfer and the terms of the two trusts are identical.

Proposed subsection 104(5.4) defines an "exempt beneficiary". An "exempt beneficiary" is a living beneficiary under the trust, who satisfies one of the following two conditions:

- (a) the beneficiary or the beneficiary's spouse or former spouse is the designated contributor in respect of the trust, or
- (b) the beneficiary or the beneficiary's spouse or former spouse is a grandparent, parent, brother, sister, child, niece or nephew of the designated contributor of the trust or of the spouse or former spouse of the designated contributor of the trust.

"Designated contributor" is defined in proposed subsection 104(5.6). The "designated contributor" in respect of a spousal trust is the individual who created (or whose will created) the trust. The "designated contributor" in respect of a testamentary trust (other than a spousal trust), is the individual as a consequence of whose death the trust was created. In any other case, the "designated contributor" in respect of the trust is an individual designated by the trust who qualifies under paragraph 104(5.6)(c).

Subparagraph 104(5.6)(c) provides that an individual, who is related to any individual beneficially interested in the trust, qualifies as a designated contributor in respect of an inter vivos trust where, throughout the relevant period, the total amount of the property previously transferred or loaned to the trust by the individual, either directly or through another trust, was greater than the amount of property loaned or transferred by anyone older who was also related to anyone beneficially interested in the trust and not less than the property transferred or loaned by anyone younger who was related to any beneficiary.

Where no individual qualifies under subparagraph 104(5.6)(c)(i), the oldest living person who transferred or loaned property to the trust and is related to a beneficiary may be designated as the designated contributor.

An individual also qualifies as a designated contributor under subparagraph 104(5.6)(c)(iii) where, during the relevant period, the property of the trust consisted primarily of:

- (a) shares of a corporation controlled, at the time the trust was created, or at the beginning of the relevant period, by such individual (or such individual and one or more other individuals born after, and related to, such individual);
- (b) shares of a corporation all or substantially all of the value of which was derived, throughout the relevant period, from

property transferred to the corporation by such individual (or such individual and one or more other individuals born after and related to such individual) and property substituted therefor;

- (c) shares in a holding corporation all or substantially all the value of which was derived, during the time the shares were held by the trust, from the shares described in paragraph (a) or (b) above, distributions in respect thereof, property substituted for such distributions, or any combination thereof;
- (d) property substituted for the shares described above;
- (e) property attributable to profits or gains with respect to the properties described above; or
- (f) any combination of the properties described above.

Paragraph 104(5.7)(a) provides that the relevant period in respect of a trust for the purposes of subsection 104(5.6) is the period commencing one year after the day the trust was created and ending on the day that would be the trust's deemed realization day if no election were made. In addition, paragraph 104(5.7)(b) provides that two individuals will be considered to be related for the purposes of subsection 104(5.6) if one of them is the aunt or uncle of the other.

Finally, paragraph 104(5.7)(c) is an anti-avoidance provision which provides that an individual will not be considered to be a designated contributor where it is reasonable to consider that one of the main purposes of a series of transactions that includes an individual becoming a trustee or a borrowing or acquisition of any property by an individual was to defer the normal deemed realization day.

New subsection 104(5.5) defines a beneficiary for the purpose of determining whether an individual is an "exempt beneficiary". A beneficiary is generally a person who has any contingent or absolute right under the trust. (The definition of "beneficially interested" previously contained in subsections 74.5(1) and 94(7) is now found in new subsection 248(25).) However, an individual shall be deemed to not be a beneficiary where the interests in the trust of all individuals, who would otherwise be exempt beneficiaries, are conditional on or subject to the exercise of a discretionary power, the exercise of which (or failure to exercise) could be used to deny all such individuals the enjoyment of any benefit in respect of their interest. This provision means that if the group of beneficiaries who are subject to the trustee's discretion includes one or more persons who would not otherwise qualify as exempt beneficiaries, then the provision would apply and it would not be possible to elect to defer the deemed disposition date. However, this qualification only applies to trusts created after February 11, 1991 or varied after February 11, 1991 so as to create an entirely discretionary trust.

The second situation in which a person will not be considered an exempt beneficiary is where it is reasonable to consider that one of the main purposes for the creation of the interest of the individual under the trust was to defer the deemed realization day. For example, where an individual is given a nominal absolute interest under the trust or a contingent interest which is virtually certain not to vest.

New subsection 104(5.8) applies where a trust transfers property to which the 21 year deemed realization rule applies to another trust on a rollover basis using either subsection 107(2) or subparagraph 54(c)(v) and the deemed realization date for the transferee trust is after what would have been the deemed realization date for the transfer trust.

Generally, the deemed realization date of the trust is advanced to that of the transferor trust. However, in certain circumstances there will be an immediate deemed realization. The first is where the transferor trust is a spousal trust, the spouse is still alive and the transferee trust is not a spousal trust. The second circumstance is where the transferee trust previously had a deemed realization date and did not make an election under subsection 104(5.3) to defer that date.

New subsection 159(6.1) would allow trusts to elect to pay the income tax arising from a 21 year deemed realization in up to ten annual instalments. Interest at the prescribed rate would apply to the unpaid tax and

the trust would be required to furnish security for the unpaid instalments and interest.

IX. NON-RESIDENT BENEFICIARIES

Non-residents of Canada are generally subject to a withholding tax of 25% (less if reduced by an applicable tax treaty) on income earned in Canada.⁸⁶ However, income from employment or a business in Canada earned by non-residents, or gains realized by non-residents from the disposition of taxable Canadian property are subject to tax under Part I of the ITA. Taxable Canadian property includes real property situate in Canada, capital property used in carrying on a business in Canada, shares of a private corporation resident in Canada, shares of a public corporation where the non-resident person or persons with whom he or she deals at non-arm's length together own more than 25% of the issued shares of any class, interests in certain partnerships and capital interests in trusts resident in Canada.⁸⁷

If a non-resident earned all his or her income through a Canadian resident trust the entire income of which was payable to non-residents, a tax advantage would be theoretically possible. The trust would be able to deduct all of its income pursuant to subsection 104(6) because it is payable to a beneficiary and the trust would therefore not pay any Part I tax. The non-resident beneficiary would also escape Part I tax because his or her

86 Subsection 212(1).

87 Paragraph 115(1)(b).

income from the trust would be considered income from property which is subject only to the withholding tax.⁸⁸ An advantage would be realized where the rate of withholding tax was less than the amount the non-resident would pay had he or she earned the income directly.

In order to prevent the availability of such an advantage, the Department of Finance has devised various rules to ensure that Part I tax is paid on certain income. Previously, the scheme was to deny the trust a deduction for income distributions to non-residents out of the trust's designated income.⁸⁹ The problem with this scheme was that where the trust had both resident and non-resident beneficiaries, the resident beneficiaries paid more tax than the non-residents. This was because the trust paid tax on its designated income so there was less income to distribute and the resident beneficiaries paid tax on the income when it was distributed to them with no credit for the tax they had paid indirectly.

New rules designed to remedy this situation were enacted to be applicable to the 1988 and subsequent taxation years.⁹⁰ Essentially, the trust is permitted to deduct all income distributed to both resident and non-resident beneficiaries, but there is a new tax, contained in Part XII.2 of the Act,⁹¹ levied

88 Section 115 and subsection 212(1).

89 Former section 108, repealed by S.C. 1988, c. 55, s. 71(4).

90 S.C. 1988, c. 55, s. 160. For a detailed explanation of the new provisions see Swiderski, T. and C. Ireland, "Trusts and Trust Beneficiaries - Not Forgotten by Tax Reform" (1988) 36 Can. Tax L. 888, at pp. 903 - 908.

91 Sections 210 - 210.3.

on the "designated income" of the trust. "Designated income" is defined in subsection 210.2(2). It is income of the trust which includes net taxable capital gains from dispositions of taxable Canadian property (as defined in paragraph 115(1)(b)) determined as if the trust is non-resident and net income from,

- (a) real properties in Canada (other than Canadian resource properties),
- (b) timber resource properties,
- (c) Canadian resource properties (acquired after 1971), and
- (d) businesses carried on in Canada.

The amount of the designated income is to be calculated without reference to the deductions available for amounts payable to a beneficiary, amounts designated to a preferred beneficiary, or the Part XII.2 tax paid by the trust.⁹²

The Part XII.2 tax is generally equal to 36% of the designated income of the trust payable to any beneficiary, whether resident or non-resident. The exact formula for calculating the amount of tax is set out in subsection 210.2(1). There are a number of trusts which are exempt from these provisions, the most important being testamentary trusts. Also exempt are mutual fund trusts, trusts exempt from Part I tax pursuant to subsection

92 The deductions available under subsections 104(6), 104(12) and 104(30) respectively.

149(1) such as registered charities, non-profit associations, etc., pension type trusts described in subparagraphs 108(1)(j)(ii) or (iv) and non-resident trusts.⁹³ The provisions also do not apply where the trustee has certified that no beneficiary under the trust was a "designated beneficiary" during the taxation year.⁹⁴

A "designated beneficiary" is essentially a non-resident person, a non-resident owned investment corporation, certain persons exempt from Part I tax by reason of subsection 149(1), a trust, other than a testamentary trust, if a designated beneficiary is a beneficiary thereunder or a partnership if a designated beneficiary is a partner thereof.⁹⁵

Subsection 210.3(2) provides that, for the purpose of certification under subsection 210.3(1) that there were no designated beneficiaries under the trust during the taxation year, a non-resident beneficiary may, in very limited circumstances, escape being a designated beneficiary. If the non-resident beneficiary's income is subject to Part I tax by reason of subsection 2(3) of the Act and he or she is not exempt from this tax by reason of any tax treaty, he or she will not be considered to be a designated beneficiary of the trust.⁹⁶

93 Section 210.1.

94 Subsection 210.3(1).

95 Section 210.

96 Swiderski and Ireland in "Trusts and Trust Beneficiaries - Not Forgotten By Tax Reform", *supra* footnote 90, at page 906 state that this provision would rarely apply as a non-resident's income from a trust would not normally be taxed under Part I. They

The Part XII.2 tax is initially paid out of the income of the trust which means the trust has less income to distribute. The trust is then entitled to a deduction equal to the amount of Part XII.2 tax paid in the year the tax was paid.⁹⁷ Beneficiaries of the trust who are not designated beneficiaries are entitled to a tax credit equal to their proportion of the Part XII.2 tax paid by the trust.⁹⁸ An amount equal to the tax credit is deemed to be payable by the trust to such beneficiaries and such amount is included in the income of these beneficiaries under subsection 104(13). Designated beneficiaries are not entitled to a tax credit and are subject to withholding tax at the rate of 25%, or less if specified by a relevant tax treaty, on any trust distribution. This means that designated beneficiaries pay tax at an effective rate of 52% on designated income.⁹⁹ The effective rate is less if the country in which the designated beneficiary resides has entered into a tax treaty with Canada which specifies a lower withholding rate.

A Part XII.2 tax return must be filed within 90 days of the trust's year end.¹⁰⁰ Trustees should be aware that a trustee is personally liable for any

suggest that the provision was added to benefit certain non-resident life insurance companies carrying on business in Canada.

97 Subsection 104(30).

98 Subsection 210.2(3).

99 See Swiderski and Ireland, "Trusts and Trust Beneficiaries - Not Forgotten by Tax Reform", *supra* footnote 90, at p. 907.

100 Subsection 210(5).

Part XII.2 tax not paid within this time. For an example of the operation of Part XII.2, see the Technical Notes accompanying the draft legislation.¹⁰¹

X. CERTAIN TRUSTS NOT RESIDENT IN CANADA

Certain trusts which are not resident in Canada may still be subject to Canadian tax under the provisions of section 94. Section 94 is included in the scheme contained within the Act of taxing non-resident corporations in certain circumstances (generally called the "FAPI rules") and is designed to prevent the avoidance or undue deferral of Canadian tax through the use of non-resident trusts.

Section 94 applies to trusts not resident in Canada if a Canadian resident directly or indirectly has a beneficial interest in the trust and, either the trust had directly or indirectly acquired property from a Canadian resident or the beneficiary had directly or indirectly acquired the trust interest from a Canadian resident. It applies to both inter vivos and testamentary trusts (subject to certain exceptions) and there is no distinction between personal and commercial trusts as there is elsewhere in the Act. The treatment under section 94 differs for discretionary and non-discretionary trusts. A discretionary trust is treated much the same as a person resident in Canada with respect to certain types of income. A non-discretionary trust is deemed to be a non-resident corporation for the purpose of attributing foreign accrual

101 "Explanatory Notes to Legislation Relating of Income Tax" in Canadian Tax Reports, Special Report No. 851, Extra Edition, June 30, 1988.

property income ("FAPI")¹⁰² to resident Canadians who have a beneficial interest in the trust.¹⁰³

A. Tests for Determining the Applicability of Section 94

The first of a two-part test to determine whether or not section 94 applies to a non-resident trust involves determining whether or not a Canadian resident has a beneficial interest in the non-resident trust. A beneficial interest is defined in subsection 94(7) as follows,

... a person is beneficially interested in a trust if that person has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of a discretionary power by any person or persons) to receive any of the income or capital of the trust either directly from the trust or indirectly through one or more other trusts.

A Canadian resident in this context is not limited to individuals, but also applies to corporations and trusts. Accordingly, the first part of the

102 Defined in paragraph 95(1)(b).

103 For an excellent discussion of the mechanics of section 94 see Ngan, S., "Foreign Trust Structures for Immigrants", (1990) 38 Can. Tax J. 1264. Also, Bradley, J.M., "Shareholders of Foreign Affiliates and Beneficiaries of Non-Resident Inter-Vivos Trusts" in Report of Proceedings of the Twenty-Sixth Tax Conference, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975), 225; Sarkari, N.P.D., "Taxation of Non-Resident Trusts", (1974) 32 Can. Tax J. 584; Kellough, H.J., "Basic Tax Considerations of Trusts and an Examination of Some Particular Types of Trusts" in Report of Proceedings of the Twenty-Seventh Tax Conference, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 478; Noble, W.R., "Some Tax Avoidance Aspects of Non-Resident Trusts", (1979) 5 Estates and Trusts Q. 81; and Cullity, M.C. Q.C., "Non-Resident Trusts" in Report of Proceedings of the Thirty-Third Tax Conference, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 646.

test to determine whether or not section 94 applies is satisfied if one or more beneficiaries of the non-resident trust is either,

- (a) a person resident in Canada,
- (b) a corporation or trust with which a person resident in Canada was not dealing at arm's length,¹⁰⁴ or
- (c) a controlled foreign affiliate¹⁰⁵ of a person resident in Canada.¹⁰⁶

The second part of the test to determine whether or not section 94 applies to a non-resident trust may be satisfied in two ways. The first alternative (the "source of property test") relates to the source from which property is acquired by the non-resident trust or by a non-resident corporation that would, if the non-resident trust were resident in Canada, be a controlled foreign affiliate of the trust. If the non-resident trust or non-resident corporation described above acquired property, either directly or indirectly, at any time in or before the taxation year from,

104 The definition of "arm's length" is found in subsection 251(1).

105 Defined in paragraph 95(1)(a).

106 Paragraph 94(1)(a).

- (a) a person who is a beneficiary who has satisfied the first part of the test set out above, was related to that person,¹⁰⁷ or was the uncle, aunt, nephew or niece of that person, and
- (b) the person was resident in Canada at any time in the 18 month period immediately before the end of the taxation year of the trust in question or, if the person ceased to exist (either died or the corporation or trust was wound up), the person was resident in Canada at any time in the 18 month period immediately before ceasing to exist, and
- (c) if the property was acquired from an individual, in addition to residence in Canada at any time in the preceding 18 month period, the individual must have been resident in Canada before the end of that year for a period or periods totalling more than 60 months.

In addition, the source of property test will be satisfied if the property was acquired from a trust or corporation which acquired the property, either directly or indirectly, from a person who satisfied the tests set out above with whom the trust or corporation was not dealing at arm's length.

107 The definition of "related" persons is found in subsection 251(2).

The source of property test looks only to the fact that property was acquired. How or why it was acquired is not an issue. Purchasing an interest in a non-resident investment trust would appear to satisfy the test. Also, subsection 94(6) deems a trust or non-resident corporation to have acquired property from any person who has given a guarantee on its behalf or has given any financial assistance whatsoever. The size of the contribution or assistance is irrelevant.

There are certain prescribed circumstances in which subsection 94(1) will not apply. Regulation 5909, applicable after October 28, 1985, prescribes that the acquisition of property by virtue of repayment of a loan is an exception and the source of property test will not apply to such a situation. It should be noted that this refers to the situation where the trust or non-resident corporation has made the loan and is being repaid. The opposite situation where the trust or non-resident corporation receives a loan almost certainly falls within the ambit of subsection 94(6) and would be considered an acquisition which may bring subsection 94(1) into play.

In addition, the source of property test does not apply to an inter vivos trust created before 1960 by a person who was a non-resident at the time the trust was created or to a testamentary trust where the death of the testator occurred before 1960.¹⁰⁸

108 Clauses 94(1)(b)(i)(C) and (D).

The alternate way in which the second part of the test to determine whether or not section 94 applies involves the source of the trust interest held by a person who has satisfied the "beneficiary" test set out in paragraph 94(1)(a) and discussed above. The "source of trust interest test" will be satisfied if, at any time during or before the taxation year of the trust in question, a beneficiary has acquired all or any part of his or her interest in the non-resident trust by way of purchase, no matter from whom the interest is purchased. Alternatively, the test will be satisfied if a beneficiary has acquired all or any part of his or her interest in the non-resident trust by way of gift, bequest or inheritance from or by the exercise of a power of appointment by a person referred to in clauses 94(1)(a)(i)(A) or (B) (a person who would satisfy the "source of property test" if the trust had acquired property from him or her). In other words, the test will be met where the beneficiary purchases a beneficial interest in the non-resident trust or acquires it by way of gift, bequest or inheritance from a person who was related to the beneficiary or was his or her uncle, aunt, nephew or niece and was resident in Canada at any time during the 18 months immediately preceding the end of the taxation year and had been prior to the end of that year resident in Canada for a total of more than 60 months. The same applies where the trust interest is acquired by way of the exercise of a power of appointment.

In addition, if the beneficiary acquires the interest by way of gift from a trust or corporation that acquired the property, directly or indirectly, from a person described above with whom it was not dealing at arm's length, the test will be satisfied.

Once it has been determined that a non-resident trust meets both the "beneficiary" test and one of either the "source of property" or "source of trust interest" tests, then the tax treatment under section 94 depends on whether the trust is a discretionary or non-discretionary trust.

B. Discretionary Non-resident Trusts

If the amount of the income or capital of the non-resident trust to be distributed at any time to any beneficiary depends on the exercise by any person or the failure to exercise any discretionary power then paragraph 94(1)(c) applies. Paragraph 94(1)(c) provides that such a non-resident discretionary trust is deemed for the purposes of Part I to be a person resident in Canada, not exempt from tax under section 149, the taxable income of which is the aggregate of the following:

- (a) the amount that would, on the basis that the trust was not resident in Canada, be its taxable income in Canada for the year. This would include income from a business carried on in Canada and taxable capital gains realized on the disposition of taxable Canadian property,¹⁰⁹
- (b) the amount that would be the trust's FAPI if the trust were treated as a non-resident corporation, and

¹⁰⁹ See section 115.

- (c) the amount required by section 91 to be included in income in respect of the FAPI of any controlled foreign affiliate of the trust less the deductions available with respect to that income under subsections 91(2), (4) and (5).

For the purpose of the foreign tax credit under section 126, the amounts of FAPI referred to in (a) and (b) above are deemed to be income from a source in the country of which the trust would be resident, if not for the deemed Canadian residence, and any tax paid by the trust (except any Canadian tax payable by virtue of section 94) on that income is deemed to be non-business-income tax paid by the trust to the government of that country.¹¹⁰

The amount of FAPI payable in the year to a beneficiary may be deducted from the taxable income of a discretionary trust which is deemed to be a Canadian resident under paragraph 94(1)(c).¹¹¹ Once the final amount of taxable income has been arrived at it will be subject to the usual rate of federal income tax. Namely 29% for an inter vivos trust and the rates applicable to an individual for a testamentary trust.

While the non-resident discretionary trust may be deemed to be a Canadian resident for the purpose of Part I, it will remain a non-resident for

110 Subparagraph 94(1)(c)(ii).

111 Subsection 94(3).

the purpose of Part XIII and will be subject to withholding tax on Canadian source income such as dividends, interest, rents and royalties. To the extent that such Canadian source income was included in the income of the trust and subject to tax by virtue of paragraph 94(1)(c), the Part XIII tax would qualify for credit under section 126.

Each person described in clauses 94(1)(b)(i)(A) or (B) (a Canadian resident beneficiary, a relation or the uncle, aunt, nephew or niece of that beneficiary who was resident in Canada at any time in the 18 month period immediately preceding the end of the taxation year and had been resident in Canada for an aggregate of more than 60 months, or a trust or corporation that acquired the property it contributed to the non-resident trust from a person described above with whom it was not dealing at arm's length) has jointly and severally with the trust the rights and obligations of the trust contained in Divisions I and J. Namely to pay tax, interest and penalties, file returns and appeal assessments. In addition, each is subject to the administration and enforcement provisions contained in Part XV. However, no amount payable under the Act may be recovered from any such person except to the extent the person has received or is entitled to enforce payment of an amount from the trust or any amount received on disposition of his or her interest in the trust.¹¹²

112 Subsection 94(2).

C. Non-discretionary Non-resident Trusts

In the situation of a non-resident trust which is subject to section 94 and does not qualify as a discretionary trust, the trust is deemed, with respect to any beneficiary under the trust the fair market value of whose beneficial interest is 10% or more of the aggregate fair market value of all beneficial interests in the trust, to be a non-resident corporation that is controlled by the beneficiary.¹¹³ This deeming provision makes the non-resident trust subject to subsection 91(1) through (4) and section 95 which deal with the inclusion in income of FAPI earned by foreign affiliates controlled by the taxpayer. The non-resident trust is deemed to be a non-resident corporation having a capital stock of a single class divided into 100 issued shares.¹¹⁴ Each beneficiary under the trust is deemed to own a proportionate number of shares equal to the proportion of the fair market value of his or her interest in the trust to the fair market value of all beneficial interests in the trust.¹¹⁵ Although a full discussion of the provisions relating to foreign affiliates is beyond the scope of this paper, a brief description is in order. Before launching into this description, however, it should be noted that the FAPI of a non-resident, non-discretionary trust is reduced by the amount of that income that may reasonably be considered as being payable in the year to

113 Subparagraph 94(1)(d)(i).

114 Subparagraph 94(1)(d)(ii).

115 Subparagraph 94(1)(d)(iii).

a beneficiary.¹¹⁶ Consequently, if the trust must distribute its income annually, calculation of the amount of FAPI will be unnecessary.

Subsection 91(1) provides that each taxpayer resident in Canada must include in his or her income for the taxation year the participating percentage of FAPI of every share owned by the taxpayer in a controlled foreign affiliate. In addition, the taxpayer is subject to attribution of the FAPI not only of a foreign affiliate controlled by him or her, but any other foreign affiliate controlled by the first foreign affiliate. A "foreign affiliate" is a corporation not resident in Canada in which a Canadian taxpayer has an "equity percentage" (ownership interest) of at least 10%.¹¹⁷ A "controlled foreign affiliate" is a foreign affiliate which is controlled by a taxpayer alone or together with up to four other Canadian residents or by a related group of which the taxpayer is a member.¹¹⁸ FAPI is generally speaking income of an investment nature such as interest, dividends, royalties and certain rents. It also includes income from a business which is not an active business and taxable capital gains except to the extent the gains arose from the disposition of property used in an active business.¹¹⁹ "Participating percentage" is defined in paragraph 95(1)(e). Where the affiliate's FAPI for the year is \$5,000 or less, the participating percentage of each share of that affiliate for the year is

116 Subsection 94(4).

117 See paragraph 95(1)(d).

118 See paragraph 95(1)(a).

119 See paragraph 95(1)(b).

deemed to be nil.¹²⁰ Where the FAPI exceeds \$5,000 for the year and the affiliate has only one class of shares, the participating percentage of each share of the affiliate is basically the owner's equity percentage in respect of that share.

The key time for determining whether or not a taxpayer must include FAPI in his income is the end of the taxation year. The taxpayer will have no FAPI unless he or she has a controlling interest in a foreign affiliate at the end of the year, regardless of whether or not such an interest was held at any other time during the year.

The taxpayer may deduct from income an amount equal to the amount of FAPI on which foreign income tax has been paid at a rate equivalent to Canadian income tax rates.¹²¹ A formula for computing the deduction is provided in paragraph 91(4)(a).

120 Subparagraph 95(1)(e)(i).

121 Subsection 91(4).

RESIDENCE OF A TRUSTI. CANADA

The primary basis for taxation of a person in Canada is residence. A person resident in Canada during a taxation year is liable for income tax on his or her world income.¹²² Consequently, the determination of residence is of utmost importance.

The definition of "person" in the ITA includes corporations and trusts, in addition to individuals.¹²³ In the case of individuals there is a fairly well developed body of statutory and judicial rules which provides adequate guidelines.¹²⁴ Although, as Mr. Justice Rand pointed out in Thomson v.

122 Subsection 2(1).

123 See subsection 248(1) and subsection 104(2).

124 With respect to the residence of an individual in Canada see section 250 which deems residence in certain circumstances and Thomson v. M.N.R., [1964] S.C.R. 209, 2 D.T.C. 812; Beament v. M.N.R., [1952] 1 S.C.R. 486, 52 D.T.C. 1183; Schujhan v. M.N.R. 62 D.T.C. 1225 (Ex. Ct.); Erikson v. The Queen, 75 D.T.C. 5429 (F.C.T.D.); The Queen v. Reeder, 75 D.T.C. 5160 (F.C.T.D.); Eastwood v. M.N.R. 75 D.T.C. 126 (T.R.B.); Morton v. M.N.R. 76 D.T.C. 1275 (T.R.B.); The Queen v. Sherwood 78 D.T.C. 6470 (F.C.T.D.); Rajotte v. M.N.R. 79 D.T.C. 436 (T.R.B.); Saunders v. M.N.R. 80 D.T.C. 6776 (T.R.B.); Roy v. M.N.R. 83 D.T.C. 576 (T.R.B.); The Queen v. Bergelt 86 D.T.C. 6063 (F.C.T.D.); Ferguson v. M.N.R. 89 D.T.C. 634 (T.C.C.) and Lee v. M.N.R. 90 D.T.C. 1014 (T.C.C.). Also, Interpretation Bulletin IT-221R2, "Determination of an Individual's Residence Status", dated February 3, 1983, MacGregor, G., "Deemed Residence" (1974) XXII Can. Tax J. 381 and Hansen, B.G., "Individual Residence" in Report of Proceedings of the Twenty-Ninth Tax Conference, 1977 Conference Report (Toronto: Canadian Tax Foundation, 1978), 682.

M.N.R., "it is quite impossible to give it a precise and inclusive definition"¹²⁵ and each case must be decided on its facts.

Similarly, in the case of corporations, an extensive body of statutory and judicial rules exists. Any corporation incorporated in Canada after April 26, 1965 is deemed to be resident in Canada.¹²⁶ For those corporations which were incorporated outside of Canada, or otherwise do not fall within subsection 250(4), the common law test was established in 1906 by the House of Lords when it determined that a corporation is resident where its central management and control abides.¹²⁷ The location of central management and control has since been refined to mean where de facto control is located.¹²⁸

With respect to trusts, however, the concept of residence is not so easily applied. A trust is not a legal entity, but instead an equitable

125 Supra, footnote 26.

126 Subsection 250(4).

127 DeBeers Consolidated Mines Ltd. v. Howe [1906], A.C. 455.

128 See Egyptian Delta Land and Investment Company Ltd. v. Todd [1929] A.C. 3 (H.L.); British Columbia Electric Railway Company Ltd. v. The King [1946] A.C. 527 (J.C.P.C.); Unit Construction Co. Ltd. v. Bullock [1960] A.C. 351 [1959] 3 W.L.R. 1022 (H.L.); Yamaska Steamship Co. Ltd. v. M.N.R. 61 D.T.C. 716 (T.R.B.); M.N.R. v. Crossley Carpets (Canada) Ltd. 69 D.T.C. 5015 (Ex. Ct.); Zehnder and Co. v. M.N.R. 70 D.T.C. 6064 (Ex. Ct.); Bedford Overseas Freighters Ltd. v. M.N.R. 70 D.T.C. 6072 (Ex. Ct.); Tara Exploration and Development Co. Ltd. v. M.N.R. 70 D.T.C. 6370 (Ex. Ct.), *aff'd* 72 D.T.C. 6288 (F.C.C.); Victoria Insurance Co. Ltd. v. M.N.R. 77 D.T.C. 320 (T.A.B.); and Gurd's Products Company Ltd. et al. v. The Queen 81 D.T.C. 5153 (F.C.T.D.).

obligation.¹²⁹ A trust involves several elements: the settlor, the trustee, the beneficiary and the trust property itself. There can be more than one of each element, trustees, beneficiaries and settlors of inter vivos trusts need not necessarily be humans, but may be corporations or other trusts, and one entity can fulfil more than one role. For example, one person can be a settlor, trustee and beneficiary of the same trust. These features make it difficult to apply the concept of residence to a trust.¹³⁰

In Canada, subsection 104(1) of the ITA specifies that a reference to a trust shall be read as a reference to the trustee having ownership or control of the trust property. Subsection 104(2) goes on to state that in respect of the trust property, the trust is deemed to be an individual. The purpose being to segregate the trust income from that of the trustee in his or her personal capacity.¹³¹ Trust income which has accrued to the credit of a beneficiary, whether or not actually paid to him or her, is included in the income of the beneficiary.¹³² Tax on the accumulating income of the trust is the liability of the trustee. It was these provisions, along with the English decision of I.R.C. v. Gull¹³³ which resulted in the common view that the

129 Kingsdale Securities Co. Ltd. v. M.N.R., 74, D.T.C. 6674 (F.C.A.) at pp. 6681-2.

130 For a good discussion of how the concepts of trust and residence are foreign to each other see O'Brien, M.L., "Residence of a Trust", (1978) 33, 34 Can. Current Tax 313.

131 For a discussion of the legislative history of these provisions see Green, R.A., "The Residence of Trusts for Income Tax Purposes", (1973) 21 Can. Tax J., 653 and Flannigan, R.D.M., "Trust Obligations and Residence", (1985) 7 Estates and Trusts Q. 83 at pp. 84-5.

132 Subsection 104(13).

133 [1937] 4 All E.R. 290.

residence of a trust is determined by the residence of the trustee.¹³⁴ However, there has been only one Canadian case dealing specifically with the residence of a trust for Canadian tax purposes, namely Thibodeau Family Trust v. The Queen.¹³⁵ Since the Thibodeau decision is of such importance, an extensive review is warranted.

A. Thibodeau Family Trust v. The Queen

The Thibodeau family trust was settled in 1968 with two Canadian resident trustees. Immediately after it was settled, the trust acquired a minority interest in Canadian resident corporations. In 1970 one of the trustees resigned. The remaining trustee, pursuant to powers contained in the trust document, appointed two additional trustees who were resident in Bermuda. At the same time, and again pursuant to powers in the trust document, the assets and administration of the trust were moved to Bermuda.

In 1972 the shares were sold for approximately \$3 million. Roughly one-third of this amount was paid to the trust and the remainder was held in escrow in Canada for a period of time. Interest was earned on the

134 See Scott-Harston, J.C., "Residence of Trusts", Report of the Proceedings of the Fifteenth Tax Conference, 1961 (Toronto:Canadian Tax Foundation) 244; Cohen, M.A., Income Taxation of Inter-Vivos Trusts, Tax Paper No. 39 (Toronto:Canadian Tax Foundation, 1964); Stikeman, H.H., "Some Problems with Trusts Under the New System", Canada Tax Letter, No. 172 (Richard de Boo Ltd.) Oct. 29, 1971 and Green, R.A., "The Residence of Trusts for Income Tax Purposes", supra, footnote 131.

135 [1978] C.T.C. 539, 78 D.T.C. 6376, sub nom. Dill v. The Queen (F.C.T.D.) See case comment at (1978), 26 Can. Tax J. 653.

money in escrow and, when it was paid to the trust, withholding tax of 15% was paid on the basis that the trust was not resident in Canada. The trust also paid income tax on the gain it calculated it had realized on the sale, on the premise that there had been a sale of taxable Canadian property by a non-resident of Canada.

The Minister assessed the trust on the basis that it was resident in Canada in the year of the sale and added to its income the interest earned on the funds in escrow as well as a taxable capital gain which the Minister alleged was realized on the sale of the shares. The capital gain was based on the Minister's assumption that the sale price of the shares was equal to the Valuation Day value of the shares. However, he alleged a 10% discount on the Valuation Day value of the shares held by the trust was warranted because the trust held a minority interest.

The argument for the trustees was that the trust was resident in Bermuda because the majority of trustees were resident in Bermuda, the trustees could act by majority decision, all meetings of the trustees were held in Bermuda and the trust assets and their administration was in Bermuda. Also, although the Canadian trustee had authority to suggest investments, he had in fact been overruled by the Bermuda trustees on a number of occasions.

The main argument on behalf of the Minister was that even if the trust was resident in Bermuda, it was also resident in Canada. The Court was asked to apply, by analogy, the cases which had established that a

corporation could have dual or multiple residence. The facts put forward by the Minister to support a finding of residence in Canada were that the Canadian trustee was resident in Canada, he had sole power to appoint other trustees, he took an active interest in trust affairs and was the principal initiator of the investment program, he negotiated the sale of the shares and he made certain decisions without first advising the other trustees.

Mr. Justice Gibson in rendering his decision lamented the fact that "there are no statutory rules or judicial decisions establishing any formula that may be employed in determining whether or not a trust is resident in Canada"¹³⁶ He then went on to consider the corporate analogy. The starting point was DeBeers Consolidated Mines, Ltd. v. Howe which stated that the appropriate test for determining the residence of a corporation was to make a factual determination of where the central management and control was exercised.¹³⁷ While this rule is fairly easy to apply where the management and control of a corporation is located in one jurisdiction, problems may arise when management and control appear to be divided among two or more jurisdictions. This problem was considered in Unit Construction Co. Ltd. v. Bullock where the court concluded that the place where central management and control abides is a question of fact and in some situations it may be divided so that a corporation may be resident in more than one jurisdiction.¹³⁸

136 Supra, footnote 135, D.T.C. at 6377.

137 Supra, footnote 127.

138 Supra, footnote 128, Lord Radcliffe at A.C., pp. 365-70.

Mr. Justice Gibson, albeit in obiter, specifically rejected the argument that a trust could have dual or multiple residence if its management and control was carried on in more than one jurisdiction. His rationale was that trustees cannot delegate any authority to co-trustees and, in any event, on the evidence before him they did not do so in the case at hand.¹³⁹ He decided that the trust was resident in Bermuda and his finding was based on the fact that a majority of the trustees were resident there and the trust document permitted a majority decision on all matters.¹⁴⁰

The Thibodeau decision contains a number of interesting features. First of all, Mr. Justice Gibson stated that by discounting the trust's shares on the basis that they were a minority interest, the Minister had "admitted" that the Canadian trustee did not control the shares and was not "the guiding mind and will" of the trust.¹⁴¹ The fact on which he based this conclusion was that the Canadian trustee personally owned a majority of the shares in question. Gibson J. appears to have concluded that if the Canadian trustee also controlled the trust's shares, then all the shares would be controlled by the same person and there would be no basis for the minority discount and no capital gain to be taxed. With all due respect, this conclusion fails to recognize that the role and obligations of a trustee are completely

139 Supra, footnote 135, p. 6385 D.T.C.

140 Ibid. p. 6386 D.T.C.

141 Ibid.

separate from those of the trustee in his or her personal capacity.¹⁴² Without further evidence, the fact that a trustee personally owns a majority of shares in a corporation should have no effect on the status of shares held by that person on trust. Therefore the issue of the minority interest was quite irrelevant to the question of residence.¹⁴³

In reaching his conclusion that there would be no basis for the minority discount if the Canadian trustee had controlled the shares owned by the trust, Mr. Justice Gibson may have had in mind the decision of the Supreme Court of Canada in M.N.R. v. Consolidated Holding Co. Ltd.¹⁴⁴ In Consolidated Holding, two brothers, HDG and RDG, each held 50% of the voting shares of Consolidated Holding Co. Ltd. ("Consolidated") which in turn owned less than 50% of the shares of M&R Ltd. HDG and RDG also personally owned one share each of M&R Ltd. and, together with a trust company, were executors and trustees of their father's estate which owned or controlled more than 50% of the shares of M&R Ltd. The father's will provided that any two trustees could bind the third.

The Minister's argument was that HDG and RDG owned indirectly through Consolidated 13,110 shares of M&R Ltd. and, in their

142 See Waters, D.W.M., Law of Trusts in Canada, 2nd ed. (Toronto, Carswell Co. Ltd.) 1984, pp.710-749.

143 For an interesting discussion of this issue, see Flannigan "Trust Obligations and Residence" *supra*, footnote 131 at p. 90.

144 69 D.T.C. 5429, *aff'd* 72 D.T.C. 6007 (S.C.C.).

respective capacities as executors, controlled an additional 16,888 shares to give them overwhelming control of M&R Ltd.

The Supreme Court of Canada held that Consolidated and M&R Ltd. were indeed associated. However, the decision was based on the finding that HDG and RDG as a group controlled Consolidated Holding Co. Ltd. and, because the two could combine to override the third executor, they also controlled, as a group of two, the majority of the shares of M&R Ltd. Therefore the two companies were associated because each was controlled by the same group. While it is not absolutely clear from the decision, the estate owned more than 50% of the voting shares of M&R Ltd. Nowhere in the decision, however, is the suggestion that the shares the two brothers owned individually be combined with the shares they owned in their capacity as executors so as to establish control.

The second interesting feature of the Thibodeau decision is the discussion relating to the rejection of the possibility of dual residence. Gibson J. denied that the principle laid down in the Unit Construction case and others with respect to the residence of corporations could be applied to trustees "because trustees cannot delegate any of their authority to co-trustees".¹⁴⁵ Therefore in his opinion it would not be possible for the residence of the trust to be other than where the trustees were located. This implies that the test used by Gibson J. was de jure control. If so, then it is contrary to the established principle with respect to individuals and

145 Supra, footnote 135, p. 6385 D.T.C.

corporations that residence is a question of fact and, in the corporate context, de facto control is determinative.¹⁴⁶ It must be noted, however, that in the Thibodeau case the Bermuda trustees had both de jure and de facto control and Mr. Justice Gibson's remarks in this context were made in obiter. Therefore, although application of the de jure concept is implied, the case cannot be taken as authority for this view.

The third feature of the Thibodeau case is that, although it is the only Canadian decision to date dealing directly with the issue of residence of a trust, it is remarkably unhelpful. Gibson J. denied that there were any statutory rules relating to the residence of trusts and that the words contained in subsection 104(1), namely that "a reference to a trust... shall be read as a reference to the trustee... having ownership of control of the trust property" were of any assistance.¹⁴⁷ He then went on to apply a judicial formula which is really only applicable to the facts of the case.¹⁴⁸ He set out several factors which he considered relevant to the inquiry and then selected two, namely that the majority of the trustees were resident in Bermuda and the trust document permitted a majority decision, without explaining the reason for his selections.¹⁴⁹

146 See Unit Construction Co. Ltd. v. Bullock, supra, footnote 128.

147 Supra, footnote 135, p. 6377 D.T.C.

148 Ibid, p. 6386 D.T.C.

149 Ibid.

It may be said that the two factors selected reflect where control of the trust assets was exercised. However, there is no express statement that control is the key issue and there is no reference to the words "ownership and control" used in the ITA. Further, the decision provides no assistance in the determination of residence where the facts are somewhat altered. For example, there is no indication of how to solve the problem of residence if the situation were such that the Canadian trustee was required to be part of the majority or that unanimity of the trustees was required.

B. IT-447

It appears that Revenue Canada was of the view that the Thibodeau decision failed to clarify the issue of determining the residence of a trust because soon after the decision it issued an Interpretation Bulletin setting out its version of the applicable tests.¹⁵⁰ The Bulletin states at the outset that the residence of a trust is a question of fact to be determined according to the circumstances of each case. It then sets out a general test which is interesting in that it has no basis either in the Income Tax Act nor the Thibodeau decision and no other authority is given.

The Bulletin states that "a trust is generally considered to reside where the trustee... who manages the trust or controls the trust assets resides"

150 Interpretation Bulletin IT - 447, "Residence of an Estate or Trust", dated May 30, 1980. Revenue Canada has affirmed its views set out in IT-447 in several Technical Interpretations. See for example those set out in sections 2-126 to 2-134 of Access to Canadian Income Tax (Butterworths) and paragraph 1761 of Window on Canadian Tax (CCH).

(emphasis added).¹⁵¹ Of course, the words used in subsection 104(1) are "ownership or control of the trust assets". No indication is given of how Revenue Canada arrived at this "management" test. However, it appears to be based on the "central management and control" test applicable to corporations. The Bulletin describes in paragraph 2 the powers and responsibilities which, in Revenue Canada's view, indicate management and control as follows:

- (a) control over changes in the trust's investment portfolio,
- (b) responsibility for the management of any business or property owned by the trust,
- (c) responsibility for any banking, and financing, arrangements for the trust,
- (d) control over any other trust assets,
- (e) ultimate responsibility for preparation of trust accounts and reporting to the beneficiaries of the trust, and
- (f) power to contract with and deal with trust advisors, e.g., auditors and lawyers.

151 Interpretation Bulletin IT-447, ibid. paragraph 1.

No authority is given for this list and the factors listed were not the subject of discussion in the Thibodeau decision. The factors do, however, correspond to the factors considered to indicate "central management and control" in the corporate context.

The Bulletin attempts to deal with the problem of multiple trustees in different jurisdictions. It states that where more than one trustee is involved in exercising management and control, the trust will reside where one trustee clearly exercises a more substantial portion of the management and control.¹⁵² Where two or more trustees exercise relatively equal control of the trust and "trustees exercising more than 50% of such management and control reside in one jurisdiction, the trust will reside in that jurisdiction".¹⁵³

In situations where it is unclear who has management and control of the trust, Revenue Canada will examine other factors such as the location where the legal rights with respect to trust assets are enforceable and the location of trust assets. Residence of beneficiaries or the settlor are not considered relevant unless one or more of them exercises management and control of the trust. The Bulletin also states that Revenue Canada may determine that a trust is resident in Canada even though another country

152 It is interesting that in the first paragraph of the Bulletin the phrase used is "management or control", but in the remainder of the document it becomes "management and control".

153 IT - 447, supra, footnote 150, par. 3.

may consider the trust to be resident there. Dual or multiple residence is not discussed however.

Revenue Canada evidently considers de facto control to be the relevant test. The Bulletin states that if some person other than a trustee exercises management and control of the trust, the trust may be found to reside where that person resides. However, the meaning of this statement is not entirely clear. It is not evident whether the authors of the Bulletin were referring to a situation where employees or agents of the trustees conduct the administration and management of the trust assets in a jurisdiction different from that where the trustee or trustees reside or to a situation where a protector has been appointed.

If it were the former, then clearly the test put forward is that of de facto control over the trust property. On the other hand, if the statement is intended to encompass the situation where a protector of the trust has been appointed, the intended test may well be that of ultimate de jure control. A protector is often appointed where a trust is intended to be resident in a tax haven or any other jurisdiction which may have an instable economic or political climate. The protector generally has the power to remove trustees and appoint new trustees, to move the trust to a new jurisdiction and change its governing law. The purpose of the appointment of a protector is to ensure that the trust continues to operate in the most advantageous manner and jurisdiction regardless of what future events may transpire.

While a protector may be given additional powers to control the administration of the trust, he or she does not generally engage in the day-to-day management or administration of the trust. Therefore, although a protector may be viewed as having ultimate de jure control over a trust, he or she would not generally be viewed as exercising management and control of the trust as that term is used in IT-447. It is reasonable to conclude, therefore, that the reference to someone other than the trustee exercising management and control of the trust contained in the Bulletin was not intended to include a protector.

Finally, IT-447 states that the residence of trustees and other persons exercising management and control is to be determined on the basis of the normal factual tests for determining the residence of an individual and, if the trustee is a corporation, the normal factual tests for determining residence of a corporation.¹⁵⁴

Although IT-447 may be seen as a valiant effort on the part of Revenue Canada to provide effective guidelines for determining the residence of a trust, its pronouncements have little or no foundation in law. Furthermore, it does not adequately address the problem of multiple trustees in different jurisdictions. It does not even provide an adequate solution where there are two trustees acting jointly in two jurisdictions or where there are multiple trustees required to act unanimously. The suggested "more than 50%" rule is not applicable. Other factors to be considered where it is not clear

¹⁵⁴ *Ibid.* par. 6 and 7.

who has management and control of the trust are suggested. Yet no explanation is offered as to why these factors are considered important or even relevant for that matter. Finally, it may be argued that where unanimity on the part of the trustees is required, it is quite clear who has management and control; all the trustees share it equally. Yet dual or multiple residence is not discussed.

Since it is clear that Canadian statutes, case law and even the administrative pronouncements of Revenue Canada do not adequately answer the question of how to determine the residence of a trust, resort must be made to other sources. To this end, this paper will now examine how the problem is resolved, if at all, in three other common law jurisdictions, namely the United Kingdom, the United States and Australia. It will also examine the proposals contained in the Report of The Royal Commission on Taxation (the "Carter Commission Report").¹⁵⁵

II. THE RESIDENCE OF TRUSTS IN OTHER JURISDICTIONS

A. United Kingdom

In the United Kingdom the issue of the residence of a trust for tax purposes has recently been the subject of some attention. In the U.K., as in Canada, liability for taxation is based on residence (with special provisions for

¹⁵⁵ Supra, footnote 2.

income earned in the U.K. or the disposition of U.K. property by a non-resident). With respect to determining the residence of a trust, until recently the U.K. experience has been similar to that of Canada in that the case law has been wholly "inadequate".¹⁵⁶ There has been for some time a statutory definition of the residence of a trust with respect to capital gains tax. However, nothing with respect to income tax.¹⁵⁷ The capital gains provision states that the trust is presumed to be resident in the U.K., but this presumption may be rebutted if two conditions are met. First, that a majority of trustees are not resident or ordinarily resident in the U.K. and second, that the general administration of the trust is carried on outside the U.K.

With respect to income tax, there was little or no guidance prior to the decision in Dawson v. Inland Revenue Commissioners.¹⁵⁸ Until Dawson the general opinion was that the common law was similar to the statutory provision with respect to capital gains, namely that a trust was resident in the U.K. unless all or a majority of the trustees were non-resident and the general administration of the trust was carried on elsewhere.¹⁵⁹ The decision of the Court of Appeal (affirmed by the House of Lords) set aside this notion and arrived at a very different conclusion.

156 See 23 Halsbury's Laws of England (4th ed.), par. 1409.

157 Capital Gains Tax Act, 1979, subsection 52(1).

158 [1987] S.T.C. 371, [1987] 1 W.L.R. 716, affm'd [1988] 3 All E.R. 753, [1988] S.T.C. 684, [1988] 1 W.L.R. 930 (C.A.), affm'd [1989] S.T.C. 473, [1989] 2 W.L.R. 858 (H.L.).

159 Halsbury's Laws of England, *supra*, footnote 156.

Dawson, a U.K. resident, was one of three trustees under three separate discretionary trusts which had been settled by a Mr. Cotton in the 1940s for the benefit of his family. At the time of the settlement Mr. Cotton and his family were resident in the U.K. They subsequently emigrated to Switzerland and became resident there. Eventually two of the trustees retired and were replaced by non-resident trustees so Mr. Dawson became the only trustee resident in the U.K.

The trust assets consisted mainly of securities in non-U.K. corporations, although there were a few small holdings in U.K. corporations and some land in England. The trusts were discretionary, consequently none of the beneficiaries had an absolute vested interest in any of the income. Distributions were decided upon at meetings of the trustees held in Switzerland. Undistributed income was accumulated by the trustees in a Swiss bank account.

With respect to the fiscal year 1975 - 76, the Commissioners of Inland Revenue assessed Mr. Dawson, the sole U.K. trustee, for tax on the whole income of the three trusts, including the foreign income. Mr. Dawson accepted liability for tax on income from the U.K. assets, but disputed any liability for the foreign income. He appealed the assessment and lost. However, the decision was reversed by Vinelot J. in 1987 and the reversal subsequently affirmed by both the Court of Appeal and House of Lords.

The statutory provisions upon which the Commissioners relied were section 108, Schedule D, paragraph 1(a) and section 114 of the Income and Corporations Taxes Act, 1970. The relevant part of section 108, Schedule D provides as follows,

Schedule D

1. Tax under this Schedule shall be charged in respect of (a) the annual profits or gains arising or accruing (i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere, and ... (iii) to any person, whether a British subject or not, although not resident in the United Kingdom, from any property whatever in the United Kingdom ...

Section 114 then identifies the persons liable for the income tax levied under Schedule D. Section 114 provides,

... income tax under Schedule D shall be charged on and paid by the persons receiving or entitled to the income in respect of which the tax is directed by the Income Tax Acts to be charged.

The central issue then identified by the Court was whether the income of the trusts was income which accrued to a person residing in the U.K. (section 108, Schedule D, paragraph 1(a)(i)) and to which that person was entitled or received (section 114).

In the Court of Appeal, both Nicholls and Dillon L.J. gave reasons with Kerr L.J. concurring with both. The Lords Justice agreed that the income of a trust accrues to the trustees thereof jointly, not jointly and severally. Therefore, the trust income did not accrue to Mr. Dawson alone, but to him jointly with his co-trustees. Similarly, he was not entitled to the

income as such, but was only entitled to it in conjunction with the other trustees.

The Lords Justice noted that if all the trustees resided in the U.K. there could be no doubt of the tax liability for both domestic and foreign income. Conversely, if all the trustees were non-resident, there would be no tax liability save that on income earned from property in the U.K. The problem then was how the provisions were to be interpreted when the income accrued jointly to persons, some of whom were non-resident.

The Crown contended that the provisions were satisfied if any of the persons were resident in the U.K. Mr. Dawson's contention was that all the persons must be resident. Nicholls L.J. noted that both interpretations produced anomalous results in some circumstances. It was tempting to construe the provisions loosely and apply by analogy the situation with capital gains and a similar situation with respect to partnerships. He declined to engage in such creative construction, however, and Dillon L.J. concurred that in the case at hand it was irrelevant where the majority of the trustees resided and where the administration took place. They agreed that on a plain reading of the relevant legislation, the qualifications of "residing in the United Kingdom" applied to all the persons when the income accrues to persons jointly. Consequently, Mr. Dawson was not liable for tax on the income earned by the trust outside the U.K.

It is interesting that Nicholls L.J. chose to add three footnotes to his decision. First, he pointed out that at the relevant time no beneficiary had an absolute vested interest in the income. Had this not been the case then the question may have arisen whether or not there was any income actually accruing to the trustees. Presumably, if a beneficiary were so entitled the final result would not have been different unless a beneficiary with such an interest were resident in the U.K.

The second point was that none of the trustees had a beneficial interest in the trust. Nicholls L.J. chose to express no view on whether the decision would be different in such circumstances. However, if Mr. Dawson had a beneficial interest in the trust, it could be argued, along the lines of the first point, that he was entitled to income in his personal capacity, apart from his joint entitlement as a trustee.

Lastly, Nicholls L.J. warned that should anyone think that his decision would pave the way for the appointment of a non-resident trustee in order to avoid U.K. tax, there were stringent anti-avoidance provisions which, although not relevant in the present case, could be invoked in other circumstances.

The Court of Appeal decision was unanimously affirmed by the House of Lords. In brief reasons, Lord Keith of Kinkel confirmed that Mr. Dawson could not alone be subject to U.K. tax while his co-trustees were not subject because the income did not accrue to Mr. Dawson personally. He

had no right or control over the income as the trustees could only act jointly. Again the resulting anomalies were deemed irrelevant and Lord Keith concluded by saying that while it might be beneficial to have tax liability dependent upon the location of the administration of the trust and the residence of the majority of the trustees, Parliament had not chosen to do so as it had with respect to capital gains.

Not surprisingly, the Dawson decision has been the subject of several comments.¹⁶⁰ In a case comment by John F. Avery Jones,¹⁶¹ he suggests that the Court could have interpreted the word "person" differently with a more palatable result. The word "person" could be interpreted to include a body of persons, corporate or unincorporate.¹⁶² In the situation of trustees then, the body could be given a single residence by reference to all the facts, much in the same way that the residence of a corporation is determined under the common law. Mr. Avery Jones refers to the Canadian decision of Thibodeau Family Trust v. The Queen¹⁶³ as an example of this approach and notes that the place of management and control is the test adopted by Revenue Canada in Interpretation Bulletin IT-447.

160 See Avery Jones, J.F., "Residence of Trustees", [1988] British Tax Rev. 359, Francis, C., "Residence of Trustees", [1988] British Tax Rev. 462, Nitikman, J.A., "Dawson v. I.R.C.", (1989) 9 Estates and Trusts J. 181 and Avery Jones, J.F., "Dawson Reversed", [1989] British Tax Rev. 359.

161 [1988] British Tax Rev. 359.

162 Mr. Avery Jones expands on this topic in a separate article, "Bodies of Persons", [1991] British Tax Rev. 453.

163 Supra, footnote 135.

Unfortunately, Mr. Avery Jones' analysis fails to include two items. First, the "management and control test" may have been adopted by Revenue Canada, but it is not necessarily supported by the case on which it relies.¹⁶⁴ Second, there is a most important difference between the Canadian and U.K. legislation. The Canadian Income Tax Act states that a trust shall be subject to tax as an individual, but then also states that any reference to a trust shall be read as a reference to the trustee (or trustees) having ownership or control of the trust property.¹⁶⁵ There is no equivalent provision in the U.K. legislation and it may be argued that the Canadian statute makes it much easier to envision the trustees as a body of persons, while the U.K. legislation focuses on the individual.

Apparently the situation resulting from the Dawson decision was not acceptable to the U.K. government for it wasted no time in amending its legislation.¹⁶⁶ Surprisingly, the solution adopted is not the same as that for capital gains tax.¹⁶⁷ The capital gains provisions operate so as to give the trustees as a body a residence by examining the place of residence of the majority of the trustees and the place of administration of the trust. The new legislation introduced with respect to income tax instead simply deems any non-resident trustees, who are co-trustees with a U.K. resident, to be resident

164 See discussion above.

165 Subsection 104(1).

166 See Finance Act, 1989, section 110.

167 Supra, footnote 157.

for the purposes of the Act. Consequently, the issue of mixed residence need never arise again. Exceptions are where a professional trustee is involved or the settlor was not at the time of settlement domiciled resident or ordinarily resident in the U.K. In such circumstances, all the trustees are deemed to be non-resident. A similar exception exists with respect to capital gains tax.

The new legislation is not intended to be retroactive and there are transitional provisions. A certain time period was given for removing U.K. resident trustees without making all the trustees resident for the taxation year.

B. Australia

In Australia a statutory solution to the question of the residence of a trust was imposed in 1979.¹⁶⁸ As of the 1978/79 taxation year, a trust is taken to be resident in Australia during a taxation year if a trustee was a resident at any time during the year or the central management and control of the trust estate was in Australia at any time during the year.¹⁶⁹

Certainly this is the most stringent test of residence of those examined thus far. Even the presence of one Australian resident trustee is sufficient to make the trust a resident trust, even though the majority of

168 S.A., No. 12 of 1979, subsection 11(1), applicable to 1978/79 and subsequent years.

169 Assessment Act, S.A. 1979, subsection 95(2). For a discussion of the amendments see Spry, I.C.F., "Further Tax Avoidance Legislation", (1979) Australian Tax Rev., 3 and Davies, G.L., "Developments in Taxation of Trusts", (1979) 15 Taxation in Australia, 3.

trustees may be resident elsewhere or its administration carried on elsewhere. The result of being resident in Australia is that the net income of the trust, including income from sources outside Australia, will be taxable there.¹⁷⁰

Such was not always the case in Australia. Prior to 1979 there was no statutory definition of the residence of a trust and there was virtually no case law dealing with the issue until The Union Fidelity Trustee Company of Australia Ltd. et al. v. The Commissioner of Taxation.¹⁷¹ The residence of the trust in question was not directly in issue in Union Fidelity. Instead the central issue was whether or not the income of the trust received from sources outside of Australia and to which no beneficiary was presently entitled, could be taxed in the hands of the trustees under section 99 of the Income Tax and Social Services Contribution Assessment Act, 1936-61. The relevant statutory provisions were as follows:

Section 99

Where there is no beneficiary presently entitled to any part of the income of a trust estate, or where there is a part of that income to which no beneficiary is so entitled, the trustee shall be assessed and liable to pay tax on the net income of the trust estate, or on that part of that net income as the case may be, as if it were the income of an individual, and were not subject to any deduction.

170 See Assessment Act, subsection 95(1).

171 (1969) 119 C.L.R. 177, 69 A.T.C. 4084 (H.C. of A.). The decision was followed in the subsequent High Court decision of Esquire Nominees Ltd. v. F.C. of T. (1972) 3 ATR 105, rev'd (1973) 4 ATR 75 (F.H.C.) on other grounds.

and

Section 95

... the net income of a trust estate means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income, less all allowable deductions, except the concessional deductions and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deduction of such of the losses of previous years as are required to be met out of corpus.

"Taxpayer" was defined in subsection 6(1) of the Act to mean a "person deriving income" and "assessable income" to mean "all the amounts which under the provisions of this Act are included in the assessable income". Subsection 25(1) provided that,

Section 25

The assessable income of a taxpayer shall include,

- (a) where the taxpayer is a resident, the gross income derived directly or indirectly from all sources whether in or out of Australia; and
- (b) where the taxpayer is a non-resident, the gross income derived directly or indirectly from all sources in Australia, which is not exempt income.

It was argued on behalf of the Commissioner that the trustee was the actual taxpayer under section 99. Since the two trustees in question were resident in Australia, it followed that they were liable for any tax imposed on foreign income.

The Court rejected the idea that liability for tax on the income of a trust depended upon the residence of the trustee. Instead, the Court accepted the appellants' argument that the trust as taxpayer was a notional individual which was separate from that of a person or a company, both for which a definition of residence was contained in the Act. Since there was no definition of the residence of a trust, it could not be treated as a resident under section 25 and was, therefore, subject to tax only on income earned in Australia. In the words of Barwick, C.J.,¹⁷²

From the actual income of the trust estate there are abstracted all sums which can be seen to be assessable income. For the purpose of this abstraction or computation the only fact which is relevantly known is that the trustee, as taxpayer, has derived the income. The residence of the trustees, or of any one of them, if there be more than one cannot afford a reason for varying the net amount of the income of the trust estate according to the accident of the trustee's residence in the year of tax. Its irrelevance is emphasized when the possibility of diverse residences of several trustees is contemplated.

Income for the relevant purposes of the Act falls into one of two categories - that which is derived from an Australian source and that which is not derived from an Australian source. The scheme of the Act is to bring to tax both kinds of income where the taxpayer deriving it is a resident of Australia but to bring to tax only income of the former kind where the taxpayer is not a resident of Australia. It is therefore clear to my mind that if nothing is known as to the residence of a taxpayer the only income which can certainly be said to be assessable income is the income derived by the taxpayer from an Australian source. Unless it is known that he is a resident, it cannot be said that any other income is to be included in his assessable income.

In separate reasons for judgment, Kitto J. expressed even greater disdain for the idea that liability for tax should depend on the residence of the

172 Supra, footnote 171, p. 181 C.L.R.

trustee.¹⁷³ He found it "highly unlikely that taxability in respect of a trust estate should depend upon so fortuitous and arbitrary a consideration as the residence for the time being of the trustee".¹⁷⁴

The Union Fidelity decision is notable for two reasons. The first reason is the outright rejection of the idea that the residence of a trustee was in any way relevant to the determination of the residence of a trust. The second reason is the unwillingness of the Court to attempt to define a common law test of the residence of a trust in the absence of a statutory definition. Barwick, C.J. simply accepted that since there was no statutory definition of the residence of a trust it must be presumed to be non-resident.

The refusal to treat the residence of a trustee as significant may be explained in part by the fact that the legislation in question made it clear that a trust was to be treated as a separate individual for tax purposes. The Australian legislation also specified that the trustee was liable for the trust's tax liability. However, however, there was no provision similar to subsection 104(1) of the Canadian ITA which states that a reference to a trust "shall be read as a reference to the trustee(s) having ownership or control of the trust property". The writer is not suggesting that subsection 104(1) or an equivalent provision is an adequate basis for equating the residence of a trust with the residence of a trustee. However, it may make it easier for a court to arrive at such a conclusion.

173 A similar opinion was stated by Menzies, J. in his reasons for judgment at p. 189 C.L.R.

174 Supra, footnote 171, p. 187 C.L.R.

The unwillingness of the Australian Court to attempt a definition of residence of a trust in the absence of a statutory definition is not something which this writer can easily explain. Nor is the ten year gap between the Union Fidelity decision and the imposition of a statutory definition of residence in Australia easily explained. In any event, the Australian experience is of interest in that it is illustrative of two extremes. At one end of the scale is the complete rejection by the Court of the relevance of the residence of the trustee in determining the residence of a trust. On the other end of the scale is the imposition of a statutory definition which would result in a trust being resident if one trustee were resident in Australia or the management and control of the trust were exercised in Australia.

C. United States

In the United States, the distinction is made, for the purpose of taxation, between a domestic trust and a foreign trust. A domestic trust is taxed on its world wide income, while a foreign trust is ordinarily taxed only on income effectively connected with the conduct of a trade or business with the U.S.¹⁷⁵ or from U.S. sources of fixed or determinable income such as interest, dividends, royalties, etc.¹⁷⁶

175 I.R.C., subsections 871(b) and 881(b).

176 I.R.C., subsections. 871(a) and 881(a).

There are, however, instances where a foreign trust will be treated as a domestic trust. For example, if a U.S. person transfers property to a foreign trust which has a U.S.

The Internal Revenue Code defines a foreign trust as one "the income of which from sources without the United States, which is not effectively connected with the conduct of a trade or business within the United States, is not includable in gross income".¹⁷⁷ Unfortunately, this definition is of no assistance in determining how a foreign trust is to be distinguished from a domestic one. Instead resort must be made to the case law and administrative rulings.

The most helpful case is B.W. Jones Trust v. Commissioner of Internal Revenue.¹⁷⁸ The trust in question was created in England by an English settlor for an English beneficiary. There were four trustees, three of whom were English and the fourth an American resident. Substantially all of the trust assets were American securities which were held in the U.S. The trustees maintained an American bank account and an office in the U.S. at which the business relating to the securities was conducted. The American and one of the English trustees had control of the trust property. The English trustee made semi-annual trips to the U.S. during which the two decided which securities were to be traded. The American trustee generally followed the English trustee's advice. Upon receipt of dividends and interest the American trustee rendered a statement and remitted funds quarterly to an English bank. Distributions were made in England by the English trustees.

beneficiary, the trust is generally treated as a "grantor" trust and the U.S. person transferring the property is taxed on the income of the trust. See I.R.C. Section 679.

177 I.R.C., paragraph 7701(a)(31).

178 (1943) 132 F. 2d 914, 43-1 U.S.T.C., Par. 9238 (CA - 4).

At issue was whether or not the trust was subject to tax on capital gains realized on the sale of securities during the years in question. If the trust were a "nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein" then it would only be subject to a withholding tax of 10% on its U.S. source income.¹⁷⁹ Otherwise it would be taxable in the ordinary way on all of its income.

The Court determined that the trust had not established that it was not resident nor that it did not have an office or place of business in the U.S. Accordingly, it was liable to pay tax on the capital gains realized by it. With respect to the issue of residence, the Court focused on the situs of the assets and the fact that the day to day administration of the trust was carried out in the U.S. by a U.S. resident trustee. The Court acknowledged that the task of determining the residence of a trust was not easy, but in this case it was relatively clear that the trust was resident in the U.S. Parker, C.J. noted that an individual or a corporation which was present and operating in the U.S. in similar circumstances would certainly be considered resident.

The Jones case illustrates that the location of the administration of the trust is important and also, possibly the residence of the trustee engaged in the administration. Although not considered by the Court, it seems likely that the same conclusion would have been reached even if the decisions with

¹⁷⁹ Internal Revenue Act of 1938, Sec. 211(a).

respect to the sale of assets were made by the English trustees and simply implemented by the American trustee.

That the trust corpus consisted of U.S. securities is less important than the fact that they were held in the U.S. This is confirmed by a later case in which a trust created in England by a English settlor with an English trustee consisted of U.S. securities held in England for the benefit of an American and an English beneficiary. It was assumed throughout that the trust was resident in England and the only issue was how the trustee could apportion the income between the beneficiaries.¹⁸⁰

Since Jones there have been few refinements of the test to determine a foreign trust. A situation very similar to that in Jones was considered in Revenue Ruling 60-81, I.R.B. 1960 - 19. A trust was established in a country other than the U.S. by a foreign testator for foreign beneficiaries. However, the trust property consisted of U.S. securities held by an American trustee in the U.S. It was ruled that the trust was resident in the United States because its assets were administered there.

That the place of administration of the trust is of utmost importance was confirmed again in another, more recent, Revenue Ruling.¹⁸¹ The trust in question was created in Canada by a Canadian organization. The beneficiaries were all Americans and the trust assets were located in the U.S.

180 Muir v. Commissioner of Internal Revenue (1950), 182 F. 2d 819 (CA - 4).

181 Rev. Rul. 70-242, 1970-1 C.B. 89.

The trustees were a mixture of U.S. and Canadian residents, but most of the administrative functions were carried out in the U.S. It was ruled that the trust was resident in the United States.

That the foreign residence of the settlor and/or the beneficiaries is not a factor in determining whether or not a trust is a foreign trust is illustrated by the case of Maximov v. U.S.¹⁸² The trust was created in the United States, expressly governed by the law of Connecticut and administered there by an American trustee. The settlor and beneficiaries were all English residents. It was argued on behalf of the trustee that the capital gains realized by the trust were not taxable in the U.S. by virtue of an Income Tax Convention entered into by the U.S. and United Kingdom which exempted from tax the capital gains of a resident of the U.K. The Court dismissed this argument, stating that the trust was a separate taxable entity, apart from its beneficiaries, and "a United States trust established in this country, governed by the laws of one of our States and administered here by an American trustee . . . is plainly not a 'resident of the United Kingdom'".¹⁸³

While the quest continues for a more definitive answer to the question of what constitutes a foreign trust,¹⁸⁴ the foregoing cases and rulings

182 (1963), 373 U.S. 49 (CA-2).

183 Ibid. p. 52.

184 See for example, Hammerman, A.H., "Foreign Situs Trusts - Defining the Undefined" (1960) 38 Taxes 529, Chopin, L.F., "The U.S. Income Tax and Foreign Trusts" (1981) 120 Trusts and Estates 43 and Newton, W.H., III, "Choice and Change of Trust Situs" (1983) 35 Univ. of Florida Law Rev. 798.

are all that is currently available. It has been suggested that the trustee's residence is most important in determining whether a trust is domestic or foreign.¹⁸⁵ However, this may be somewhat misleading in that the situations used as authority all involved a single trustee. Certainly the place of administration of the trust assets is the governing factor when multiple trustees of varying residence are involved. It may be argued that the place of administration is the critical factor in all situations as the place of administration of the trust and residence of the trustee are almost always the same in the case of a single trustee.

III. CARTER COMMISSION REPORT

The Carter Commission made its report to Parliament in December, 1966. Among its proposals were those relating to the residence of trusts.¹⁸⁶ It concluded that the test for determining the residence of a trust should continue to be primarily the residence of the trustees. However, a statutory definition which stated as precisely as possible the test for residence was thought to be preferable. It was suggested that a trust should be taxed as a Canadian resident in either of the following circumstances:

185 See Newton, "Choice and Change of Trust Situs", *supra*, footnote 184, at p. 799.

186 *Supra*, footnote 2, Vol. 4, p. 195.

- (a) when the trustees, a majority of the trustees, or a controlling group of the trustees are resident or ordinarily resident in Canada;
- (b) when a trust carries on substantially all of its business in Canada or where substantially all of its property is situated in Canada.

It was further recommended that a trust administered by a Canadian incorporated professional trustee should not be considered resident in Canada for a taxation year if the trust received substantially all of its property from a non-resident, all or substantially all, of the assets were situated outside Canada and all, or a majority, of the beneficiaries were non-residents. This latter recommendation is similar to the exemptions provided in the U.K. legislation discussed above.

The recommendations contained in the Carter Commission Report are similar to the residence test contained in the U.K. Capital Gains Act. However, the Carter Commission recommendations go even further in that they include an element of de facto control as well. If the Carter Commission recommendations were adopted, a trust would be resident in Canada not only if a majority of the trustees were resident in Canada, but if a controlling group of trustees, even though they may not form the majority, is resident or ordinarily resident in Canada.

The recommendations contained in the Carter Commission Report also go beyond any of the tests discussed above in that they propose that the trust be considered resident in Canada not only if substantially all of its business is carried on in Canada, but if substantially all of its property is situated in Canada. This is the first test encountered so far which includes reference to the location of a trust's assets.

4. ANALYSIS OF THE VARIOUS TESTS OF RESIDENCE

Having described various tests which may be used for the purpose of determining the residence of a trust, the next step is to analyze these tests and attempt to determine which is the most satisfactory. However, prior to such analysis it is necessary to deal with some preliminary matters. The first is to identify the taxable entity the residence of which is the subject of enquiry. The next step is to determine the standards against which the tests of residence are to be measured.

I. WHO OR WHAT IS THE TAXABLE ENTITY?

When considering the residence of an individual or a corporation, it is clear who or what is the taxable entity the residence of which is the subject of consideration. However, in the case of a trust it is not at all clear who or what is the taxable entity. The problem stems from the fact that a trust is not legal entity, but rather an equitable obligation imposed upon the trustee as legal owner of the trust property. There is a tendency to focus on the trustee primarily because it is the trustee against whom enforcement measures may most easily be taken. However, it is conceivable that a trust, while not a legal entity, can be a taxable entity.

As pointed out by at least two commentators,¹⁸⁷ there has been considerable confusion in the legislative history of the trust provisions in the ITA as to whether the taxable entity is the trust itself or the trustee. To recap the legislative history briefly, in the original Income War Tax Act, 1917¹⁸⁸ "person" was defined to include a trust. This implies that the trust itself was a taxable entity. However, no provision was made to designate the person against whom the trust tax liability was to be enforced. Three years later, the Act was amended to provide that trust income that had accrued to the credit of a beneficiary was to be included in the beneficiary's income, while accumulating income for the benefit of unascertained persons or persons with contingent interests was to be taxed in the hands of the trustees as if such income were "the income of an unmarried person".¹⁸⁹ However, the provision defining a trust as a person and thereby subject to the general charging provision was not repealed until 1927.¹⁹⁰ Accordingly, during the intervening period both the trust and the trustee were taxable entities.

The drafters of subsequent amendments have continued to vacillate between having the trust as a taxable entity and the trustee as a taxable entity. A 1934 amendment¹⁹¹ provided that a dividend received by an

187 See R.A. Green, "The Residence of Trust for Income Tax Purposes" and R.D.M. Flannigan, "Trust Obligations and Residence", *supra*, footnote 131.

188 S.C. 1917, c. 28, s. 2(d).

189 An Act to amend the Income War Tax Act, 1917, S.C. 1920, c. 49, s. 4.

190 R.S.C. 1927, c. 97, s. 2(h).

191 S.C. 1934, c. 55, s. 8.

estate or trust and capitalized was "taxable income of the estate or trust". However, a 1940 amendment stated that income received by an estate or trust and capitalized was to be "taxable in the hands of the executors or trustees...".¹⁹²

In 1948, the Income War Tax Act, 1917 was replaced by the Income Tax Act.¹⁹³ It contained a scheme which has continued virtually unchanged to the present day. A trust is not included in the definition of a "person".¹⁹⁴ However, in respect of trust property a trust is deemed to be an individual. An individual is defined in section 248(1) to be a person other than a corporation. Therefore, a trust is an individual and would appear to be a taxable entity. However, subsection 104(1) states that in the Act the word "trust" is to be read as a reference to the trustee. Therefore, there is confusion as to whether it is the trust that is the taxable entity or the trustee.

As stated by Richard A. Green,¹⁹⁵ if the word "trust" in subsection 104(2) is replaced by the word "trustee", the effect is that a trustee is deemed to be an individual in his capacity as a trustee. Therefore, the trustee in his capacity as trustee, becomes the taxable entity instead of the trust. Accordingly, it may be incorrect to speak of resident or non-resident trusts

¹⁹² S.C. 1940, c. 34, s. 19.

¹⁹³ S.C. 1948, c. 52.

¹⁹⁴ Section 248(1) and Burns v. M.N.R. (1946) 2 D.T.C. 893 (S.C.C.) at 896.

¹⁹⁵ "The Residence of Trusts" supra footnote 131.

and be more accurate to speak of a trust the trustee of which is resident in Canada.

As compelling as this argument may be, it was not the analysis adopted by the Court in Thibodeau Family Trust v. The Queen.¹⁹⁶ In that case, Mr. Justice Gibson clearly considered the trust to be the taxable entity and his consideration of the residence of the trustees was simply a means of determining the residence of the trust.

In the U.K. at the time of Dawson v. Inland Revenue Commissioners,¹⁹⁷ clearly the taxable entity with respect to income (as opposed to capital gains) was the trustee. This has not been altered by the subsequent statutory amendments reversing the decision in Dawson which simply deems trustees to be resident for the purposes of taxing a trust's accumulating income. The U.K. rules with respect to taxation of capital gains realized by a trust appear to treat the trust as the taxable entity.

In Australia, the decision in The Union Fidelity Trustee Company of Australia Ltd. et al. v. The Commissioner of Taxation¹⁹⁸ was that the trust itself was a taxable entity, but since there was no definition of the residence of the trust contained in the statute, the trust must be considered

¹⁹⁶ Supra footnote 135.

¹⁹⁷ Supra, footnote 158.

¹⁹⁸ Supra, footnote 171.

not resident in Australia. The statute was subsequently amended to provide rules for determining the residence of a trust.

A trust itself is considered a taxable entity in the U.S. as well, as evidenced by the Internal Revenue Code and B.W. Jones Trust v. Commissioner of Internal Revenue.¹⁹⁹

It is suggested that the correct approach is to regard the trust as the taxable entity, as opposed to the trustee. Further, analysis of the residence of a trust should focus on various connecting factors which connect a trust to a particular jurisdiction. The trustee or trustees would obviously constitute one of those connecting factors and may well be the most important connecting factor. The trustees, as legal owners of the trust property, would also logically be the subject of provisions designed to enforce payment of the trust's tax liability.

II. TAX POLICY GOALS IN GENERAL

The primary purpose of any tax system is to generate revenue to finance government expenditures. However, it is generally accepted that the pursuit of this goal is to be tempered by other considerations such as fairness and efficiency.

¹⁹⁹ Supra footnotes 175, 176 and 178, respectively.

The criteria for judging a tax system are generally accepted as including equity, both horizontal and vertical, neutrality or efficiency, economic growth and ease of administration and collection for both taxpayers and governments.²⁰⁰ Another consideration is that of the "benefit theory" or in other words, the principle that those who enjoy the benefit of government expenditures should contribute to their cost.

Horizontal equity is achieved when taxpayers in similar circumstances receive similar tax treatment. Vertical equity is achieved when tax liability increases in accordance with the taxpayer's ability to pay.

Neutrality or efficiency is achieved when the tax system does not play a role in personal or investment decisions. It is thought to be desirable because it promotes the most efficient allocation of resources. Economic growth generally refers to the balance that must be struck between maximizing tax revenue and encouraging, or at least not discouraging, economic activity.

Last, but certainly not least, is the ease of compliance and enforcement. It is generally accepted that tax laws should be relatively simple and facilitate both compliance on the part of the taxpayer and administration and enforcement on the part of tax authorities.

²⁰⁰ See Boadway, R.W., and Kitchen, H.M., Canadian Tax Policy, 2nd ed., Canadian Tax Paper No. 76 (Toronto: Canadian Tax Foundation, 1984) p. 7. See also Salyzyn, V., Canadian Income Tax Policy: An Economic Evaluation, 4th ed., CCH Canadian Ltd. (Don Mills, Ont., 1990), Chapter 2.

In order for taxing jurisdiction to be effectively exercised by a country, there must be some nexus or connection between that country and the taxpayer. The two primary bases on which countries exercise taxing jurisdiction are residence and source of income. Taxation on the basis of source of income is very common. Most countries tax income that arises or has a source within that country. When source of income is the basis for taxation, the connection with the taxing jurisdiction is obvious and enforcement relatively straightforward. Most countries rely on a system of withholding at source.²⁰¹

Most countries, in addition to taxation at source, also tax on the basis of residence or citizenship. When the basis for taxing jurisdiction is that of residence, the nexus with the taxing jurisdiction is the resident who is taxed on his, her or its worldwide income. Again enforcement of tax liability is relatively straight forward in that most residents would have sufficient assets located within the jurisdiction.

Those jurisdictions which tax on the basis of residence must also establish rules for dealing with foreign source income earned by its residents. The tax policy considerations applicable to the taxation of foreign-based income are generally the same as those discussed above, but take into account

²⁰¹ Canada is no exception. The relevant provisions of the ITA are contained in Part XIII.

the international elements.²⁰² While the primary goal of the taxation of foreign-based income is generally to raise revenue, consideration must also be given to equity, neutrality and the ease of compliance and enforcement. In addition, the taxation of foreign-based income is constrained by treaty obligations, fundamental conventions of international taxation and the tax systems of other countries. One of the primary conventions of international taxation is that of "source rights". In other words, the country in which the income is earned, the "source" country, is primarily entitled to tax revenue.²⁰³

Any jurisdiction which taxes foreign-based income must somehow deal with the international double taxation which is almost certain to result. "International double taxation" occurs when the income or capital gain earned by a person is subject to similar tax by two or more jurisdictions at the same time. Tax treaties between taxing jurisdictions deal with many issues relating to international double taxation. Tax treaties generally first establish guidelines for determining residence and then set out rules which govern how a resident of one jurisdiction is to be treated for tax purposes by the other jurisdiction in various circumstances. The general purpose of most tax treaties is to reduce the incidence of double taxation of residents of the signatory jurisdictions and to limit, in situations where double taxation is permitted to occur, the rate of tax to be levied by one jurisdiction on a resident of the other jurisdiction.

²⁰² *Ibid*, p. 52.

²⁰³ See Brean, D.J.S., International Issues in Taxation: The Canadian Perspective, Canadian Tax Paper No. 75 (Toronto: Canadian Tax Foundation, 1984).

For example, the Canada-U.S. Treaty²⁰⁴ provides in Article VII that business profits earned by a resident of one Contracting State shall be taxable only in that State unless the resident carries on a business in the other Contracting State through a permanent establishment situated therein. Therefore a U.S. resident may earn business profits in Canada and not be subject to Canadian tax as long as the U.S. resident does not have a permanent establishment in Canada.²⁰⁵

An example of the Canada-U.S. Treaty limiting the amount of tax levied by one jurisdiction on a resident of the other jurisdiction may be found in Article XI. Article XI(2) effectively limits the tax levied on interest earned by a resident of the other Contracting State to 15% (subject to certain circumstances in which no tax is levied).

While tax treaties provide the rules which govern the tax treatment of residents of the signatory jurisdictions, there are generally also domestic rules which deal with situations in which a resident has been subject to international double taxation. There are three common methods for providing relief from international double taxation incurred by a resident of a particular taxing jurisdiction. These include:

204 Canada-United States Income Tax Convention, 1980.

205 For an excellent discussion of the concept of permanent establishment see Tremblay, R.G., "Permanent Establishments in Canada", Report of the Proceedings of the Forty-First Tax Conference, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990) 38:1.

- (a) a deduction for foreign taxes;
- (b) a credit for foreign taxes; and
- (c) an exemption for foreign-source income.

In Canada the provisions relating to credit for foreign taxes are contained in section 126 of the ITA.

Assuming that the basis for tax is going to be residence, all of the foregoing tax policy considerations must be taken into account when formulating the appropriate test for residence within a jurisdiction.

If the sole consideration were that of generating revenue, then residence would be defined broadly so as to permit the country to cast its taxation net as widely as possible. However, there are other considerations and constraints. The primary constraint being that of ease of enforcement. Therefore residence is generally defined in terms of various connecting factors to the taxing jurisdiction.

III. THE USE OF CONNECTING FACTORS IN DEFINING JURISDICTION TO TAX

With respect to individuals, residence is generally based on three connecting factors, namely physical presence within the jurisdiction for a

significant period, the maintenance of a home within the jurisdiction and other social and economic ties to the jurisdiction such as the maintenance of membership in social or business organizations, the maintenance of bank accounts or investment, registration as a voter and holding a driver's license.²⁰⁶

With respect to corporations, residence is generally determined on the basis of two connecting factors. The first is place of incorporation and the second is place of management.²⁰⁷ The place of incorporation test on its own is somewhat arbitrary and unrelated to economic reality.²⁰⁸ The place of management test often, but not necessarily, results in residence in the jurisdiction in which assets are located and income received.

A. Williams v. The Queen

The use of connecting factors in resolving issues of jurisdiction to tax was recently adopted by the Supreme Court of Canada in Williams v. The Queen.²⁰⁹ The issue in Williams was whether unemployment insurance benefits (the "Benefits") received by an Indian were subject to income tax. If

206 Supra, footnote 124.

207 See discussion at page 55 above.

208 See Arnold, B.J., The Taxation of Foreign-Controlled Corporations, an International Comparison, Canadian Tax Paper No. 78 (Toronto: Canadian Tax Foundation, 1986) p. 66.

209 92 D.T.C. 6320 (S.C.C.), reversing 90 D.T.C. 6399 (F.C.A.).

the Benefits were determined to be the personal property of an Indian situated on a reserve, then they were exempt from tax by virtue of paragraph 87(b) of the Indian Act.²¹⁰

The test of situs put forward by the Minister and adopted by the Federal Court of Appeal was the well-established "residence of the debtor" test used in conflicts of law situations. However, the Supreme Court of Canada having explored the purpose of the exemption from tax, the nature of the Benefits in question and the manner in which the Benefits were taxed, determined that a more appropriate test for situs was one which focused on the relevant "connecting factors". Mr. Justice Gonthier, speaking for the Court, noted as follows:

It is desirable, when construing exemptions from taxation, to develop criteria which are predictable in their application, so that the taxpayers involved may plan their affairs appropriately.²¹¹

The advantage of using connecting factors according to the Court was the flexibility afforded. The relative importance of a particular factor would depend upon the factual circumstances. The Court cautioned that the balancing of the various connecting factors must take place within the context of the legislative scheme. Mr. Justice Gonthier stated as follows:

210 R.S.C. 1985, c. I-5.

211 Supra, footnote 209 at p. 6326.

... it would be dangerous to balance connecting factors in an abstract manner, divorced from the purpose of the exemption under the *Indian Act*. A connecting factor is only relevant in so much as it identifies the location of the property in question for the purposes of the *Indian Act*. In particular categories of cases, therefore, one connecting factor may have much more weight than another. It would be easy in balancing connecting factors on a case by case basis to lose sight of this.

However, an overly rigid test which identified one of two factors as having controlling force has its own potential pitfalls. Such a test would be open to manipulation and abuse, and in focusing on two few factors could miss the purposes of the exemption in the *Indian Act* as easily as a test which indiscriminately focuses on too many.²¹²

The Court adopted a two-step process in order to determine the appropriate connecting factors. The first step was to identify the various connecting factors which may be relevant. The second was to determine the weight to be given to each connecting factor in light of the purpose of the legislative scheme.

It is suggested that rules for determining the residence of a trust should, as in the case of individuals and corporations, be based on connecting factors and that the process outlined by the Supreme Court of Canada in Williams for identifying the appropriate connecting factors should be adopted. While the Court in Williams was concerned with determining the situs of property for the purposes of a tax exemption, it is submitted that the analysis and process applied is also appropriate for determining the residence of a trust for tax purposes.

212 Ibid.

According to the process set out in Williams, the task at hand is to first determine which connecting factors are potentially relevant. Then, while keeping in mind various tax policy goals, it must be determined which connecting factors are of primary importance. Finally, it must be determined which test of residence, utilizing one or more connecting factors, accomplishes the best results.

B. The Possible Connecting Factors

With respect to a trust, the connecting factors which are potentially relevant are as follows:

- (a) the residence of the settlor in the jurisdiction at the time of settlement or, in the case of a testamentary trust, the residence of the testator in the jurisdiction at the time of death;
- (b) the residence of one or more beneficiaries within the jurisdiction;
- (c) the residence of one or more trustees within the jurisdiction;
- (d) the location of the trust administration within the jurisdiction;
and
- (e) the location of trust assets within the jurisdiction.

C. The Application of Tax Policy Goals to the Residence of Trusts

Because the raising of revenue is a primary goal, a test to determine residence should be defined as broadly as possible without serious compromise of the other policy objectives. If a trust is determined to be not resident in Canada and has no Canadian-source income, there potentially could be no Canadian tax payable even if there is an eventual distribution to Canadian beneficiaries. This is because in most situations accumulating income is capitalized and capital distributions are not taxed in the hands of a beneficiary when received.²¹³ Therefore if the rules with respect to the residence of a trust are too generous, there is potential for not only a deferral of Canadian tax, but avoidance of Canadian tax altogether.²¹⁴ Such would not only result in a loss of revenue, but offend the "benefit theory" as well.

The principle of horizontal equity demands that trusts with similar features be taxed similarly. Vertical equity is less of a consideration with respect to trusts. For the purposes of this paper it will be assumed that it can be accomplished simply by making trusts subject to progressive tax rates.

The goal of neutrality when applied to trusts demands that, assuming sufficient connecting factors exist, the transfer of capital and

²¹³ Clause 104(13)(c)(ii).

²¹⁴ It is this potential for deferral or avoidance at which section 94, discussed above, is directed.

accumulation of income should receive similar tax treatment whether it occurs inside or outside Canada.

Last, but certainly not least, is the ease of compliance and enforcement. It is generally accepted that tax laws should be relatively simple and facilitate both compliance on the part of a taxpayer and administration and enforcement on the part of tax authorities. The facilitation of enforcement of tax laws requires that there be access either to assets or persons with some measure of control over those assets. There is little point in enacting rules which produce Canadian tax liability in situations where there are no assets in Canada nor funds flowing to or accessible by Canadian residents.

With respect to their application to trusts, the foregoing tax policy considerations may be summarized as follows:

- (a) trusts with sufficient connections to Canada should be subject to Canadian tax;
- (b) trusts with certain common features i.e., sufficient Canadian connections, should be subject to similar amounts of Canadian tax;

- (c) the avoidance or deferral of Canadian tax by transferring capital out of Canada and permitting income to accumulate off-shore should be discouraged; and
- (d) there should be no Canadian tax liability unless there are assets in Canada, foreign source income flowing to Canadians or control exercised over foreign source income or assets by Canadians.

It should be noted that these tax policy goals are relevant not only in determining the most appropriate connecting factors, but also in analyzing the various tests of trust residence in general.

D. Analysis of the Various Connecting Factors

The first possible connecting factor involves the settlor of the trust or testator in the case of a testamentary trust. This is one of the weaker connecting factors, primarily because the residence of the trust is important for the purpose of taxing the income earned by the trust. The settlement of a trust would constitute a disposition of property by the settlor and, if a taxable gain is realized on that disposition, the settlor will be liable for the resulting tax. Once the trust is settled, the settlor does not generally retain control over the trust property.²¹⁵ In the case of a testamentary trust the testator, being

²¹⁵ As discussed above, if the settlor does retain an element of control, there may be attribution pursuant to subsection 75(2).

deceased, is of course no longer in the picture. If the residence of the settlor/testator were the only connection with a particular jurisdiction, then there would be no connection with the income earned by the trust and no means of enforcement against the income or the persons in control of it. Therefore, the residence of the settlor/testator is not a strong connecting factor because there is no logical connection with the income earned by the trust itself during the life of the trust.

Residence of the beneficiaries is also not a strong connecting factor for similar reasons.²¹⁶ A beneficiary will normally be subject to tax, under either Part I or Part XIII of the Act, when trust income becomes payable to him or her. An exception is where trust income is capitalized and paid to a beneficiary in full or partial satisfaction of his or her capital interest in the trust. However, the residence of a trust is important for the purpose of taxing the income accumulating in the trust. If the beneficiary were the only connection with a particular jurisdiction, until the beneficiary was entitled to enforce payment from the trust, there would be no means of enforcement against the trust income or the persons in control of it.

In essence, both the residence of the settlor/testator and the residence of the beneficiary are weak connecting factors because neither the settlor/testator nor the beneficiary have any measure of control over the trust

²¹⁶ Holden v. M.N.R. (1933) 1 D.T.C. 243 (J.C.P.C.) is often cited as authority for the proposition that the residence of the beneficiaries is irrelevant to the determination of trust residence. However, upon close examination the decision does not establish such a proposition.

property except at the beginning and at the end of the trust respectively and it is the middle portion of the trust, or in other words the accumulation period, which is relevant for our purposes.

The residence of the trustee or trustees is, on the other hand, a very strong connecting factor. In fact, it is the connecting factor most consistently adopted as part of a test of trust residence. The reason is that the trustee has direct control over the trust property and the income earned by that property. The trustee is, therefore, the most direct link to that which makes the determination of residence of a trust necessary in the first place, namely the accumulating income of the trust.

The trustee is clearly the most direct link with the trust. However, the question remains whether the trustee's place of residence is of primary importance or if the most important factor is the place where the trustee's control is actually exercised. In other words, the place where the administration of the trust actually takes place. Often the residence of the trustee and the place of administration are the same, particularly when there is a sole trustee. However, such is not necessarily the case. In the situation of multiple trustees with different places of residence, the place of administration may well become the strongest connecting factor.

The location of trust assets is a less important connecting factor. While the location of the assets may well coincide with the place of administration and residence of the trustee, it need not necessarily do so.

Where the location of the trust assets is the only connecting factor, there may be a logical connection with the income produced by that particular asset, but not the income accumulated by the trust itself.

The location of the trust assets is a somewhat stronger connection than that of the residence of the settlor or beneficiaries because there is at least some connection with the trust's accumulating income. However, there is only a partial connection at best.

To summarize, the most important connecting factors appear to be the residence of the trustee or trustees and the place of administration of the trust. These connecting factors are of primary importance because they satisfy at least two of the four tax policy considerations summarized above. The two tax policy considerations which would be satisfied are first, that trusts with sufficient connections to Canada should be subject to Canadian tax and second, that there should be no Canadian tax liability unless there are assets in Canada, foreign source income flowing to Canadians or control exercised over foreign source income or assets by Canadians.

The location of trust assets is a less satisfactory connecting factor because it is less effective in accomplishing the same policy considerations.

The residence of the settlor and beneficiaries are weak connecting factors and are therefore considered inappropriate for inclusion in the test of residence of a trust. Yet the tax policy objectives of horizontal

equity and neutrality require that taxpayers in similar circumstances be subject to similar amounts of tax and that the tax treatment of trusts not factor into the decision of a Canadian resident creating a non-resident, as opposed to a resident, trust. In order to achieve these tax policy objectives, the accumulating income of trusts which have substantial connections to Canada should be subject to the same or similar tax treatment regardless of whether that income is accumulated in Canada or outside Canada. In other words, if Canadian resident trusts are subject to Canadian tax, it should not be possible for Canadians to avoid or defer tax through the use of a non-resident trust.

The current method of achieving this result is section 94 of the ITA which deems a non-resident trust with sufficient Canadian connections i.e., Canadian beneficiaries and a Canadian resident contributing property to the trust, to be resident in Canada and subject to Canadian tax on its FAPI.²¹⁷ The policy objective with respect to ease of enforcement and fairness to the taxpayer is achieved by providing that no amount payable under these provisions may be collected from a person except to the extent that person has received funds or is entitled to enforce payment from the trust.

One question to be resolved is whether the tax policy goals are well served by this statutory scheme or if Canadian residence should be

²¹⁷ See the testimony of R.A. Short of the Tax Policy Branch of the Department of Finance before the Standing Senate Committee on Banking, Trade and Commerce in *Proceedings*, No. 31, March 12, 1975 at page 41 wherein Mr. Short stated "if FAPI works effectively, people will not establish trusts and corporations as tax avoidance vehicles in some of the tax haven countries ...".

defined with respect to trusts in such a manner so as to make trusts with such Canadian connections resident in Canada in the first place.

IV. ANALYSIS OF THE VARIOUS TESTS FOR DETERMINING RESIDENCE

To recap briefly, the tests for trust residence examined so far include the following:

- (a) the test set out in Thibodeau, being the residence of the majority of the trustees having de jure control over the trust property;
- (b) the tests set out in IT-447 which are ostensibly based on the residence of the majority of trustees, but also include de facto control of the trust property;
- (c) the U.K. statutory test for the taxation of capital gains which consists of a presumption that the trust is resident. This presumption may be rebutted if the majority of trustees are neither resident nor ordinarily resident in the jurisdiction and the general administration of the trust is not carried out in the jurisdiction;

- (d) the test set out in Dawson,²¹⁸ being that the trust is not resident unless all the trustees are resident;
- (e) the U.K. statutory test with respect to income, being that if one trustee is resident, all the trustees are deemed to be resident;
- (f) the Australian test, namely that the trust is resident if there is at least one resident trustee or if the general administration of the trust is carried on in the jurisdiction;
- (g) the U.S. test which is based on the place of the administration of the trust; and
- (h) the Carter Commission tests, namely that a trust is resident if a majority or a controlling group of trustees is resident, substantially all the trust business is carried on in the jurisdiction, or substantially all the trust assets are situated within the jurisdiction.

The tests utilized all fall within one of four general categories, although some jurisdictions use a combination of tests. It is useful at this point to analyze the nature of these general categories and explore the

218 Supra, footnote 158.

advantages and disadvantages of each. The four general categories of tests employed to determine the residence of a trust are:

- (1) residence of the trustees, whether actual or deemed;
- (2) where control of the trust is exercised;
- (3) where the trust property is administered; and
- (4) where the trust property is located.

These tests generally coincide with the connecting factors examined above with the exception that none of the tests looks to the residence of the beneficiaries or the residence of the settlor at the time of settlement.

A. Residence of the Trustees

The most common test employed for determining the residence of a trust is where the trustee resides or, in the case of multiple trustees, where the majority of the trustees reside. This test utilizes only one connecting factor, namely the residence of the trustee or trustees, although other connecting factors may be present. The most obvious criticism of this test is that in the case of multiple trustees, all of whom reside in different jurisdictions, it would not be possible to determine where the majority resided. This is not necessarily a valid criticism however. Arguably, for

Canadian tax purposes the only relevant determination is whether or not the trust is resident in Canada. Therefore for Canadian tax purposes it is not necessary to determine in which foreign jurisdiction the trust is resident, only that it is not resident in Canada. If this test were utilized and a majority of the trustees was not resident in Canada then, for Canadian tax purposes, the trust would be non-resident. The ability to determine the jurisdiction in which the trust is resident becomes important, however, if the trust earns Canadian source income and it is necessary to determine the applicable tax treaty, if any. Although in such a situation, one generally applies the law of the jurisdiction in which one is attempting to establish residence to determine if the trust is resident there.

Assuming it is necessary to determine where exactly the trust is resident, the "majority of trustees" test would not be adequate where there was an even number of trustees, half of whom were non-resident. It would not be possible to determine residence on the basis of majority and consideration would have to be given to other factors. Another alternative is to adopt the "deeming" test utilized in Australia and in the U.K. with respect to income tax. The "deeming" test operates when at least one trustee is resident in the jurisdiction and deems all the trustees to be so resident. This neatly eliminates the problem of determining where the majority resides. However, other problems take its place. First, the test is arbitrary and pays no heed to the presence of connecting factors to the jurisdiction. It is conceivable that the sole resident trustee is the only connection to that jurisdiction. Second, there are likely to be problems with enforcement of the tax liability. It

would be unreasonable to expect to enforce the trust's entire tax liability against that single trustee resident in the jurisdiction, particularly if that trustee were unable to exert any control over the trust assets.

It is an underlying assumption of the majority of trustees test that the majority of trustees has control of the trust property. However, this is not necessarily so. It is conceivable for one of a group of trustees to have a veto power. Therefore a trust which had a majority of trustees residing outside Canada and only one Canadian resident trustee who nonetheless controlled the trust would be considered not resident in Canada. Also, a trust which had one Canadian resident trustee and two non-resident trustees, but which was administered in Canada or was otherwise substantially connected to Canada would be considered non-resident.

A further disadvantage of the majority of trustees test is that it is easily manipulated. In other words, it would be possible to make a trust not resident in Canada simply by choosing non-resident trustees. Also, the residence of a trust could inadvertently change simply upon the substitution, addition or change of residence of a single trustee, even though all of the other elements of the trust remain the same. The consequences of such a change in residence, especially for a Canadian resident trust becoming non-resident, could be substantial if the trust property had large accrued gains.²¹⁹

²¹⁹ Section 48 currently provides for a deemed disposition of certain property where a taxpayer, which includes a trust, has ceased to be resident in Canada. This would be

When the tax policy considerations set out above are applied to the majority of trustees test certain deficiencies become evident. Revenue will not necessarily be maximized because the test is easily subject to manipulation, i.e., it is easy to make the trust non-resident by appointing non-resident trustees even though there may be substantial connecting factors to Canada such as a Canadian settlor or Canadian beneficiaries. This is true whether the test is based on actual or deemed residence. For this reason, the test also does not satisfy the horizontal equity, neutrality and benefit criteria. The only criteria which may be satisfied is that of enforcement. If a trust were resident upon application of the majority of trustees test, presumably those who control the trust assets would be easily accessible to Canadian revenue authorities. However, this would not be the case where de facto control over the assets was exercised by non-residents. It would also not be the case where the controlling trustees were simply deemed to be resident and were actually resident elsewhere.²²⁰

B. Where Control of the Trust Property is Exercised

Control of the trust property can consist of de jure or legal control of the trust property or de facto or actual control. Often de jure and de facto control are exercised together, but such is not necessarily the case.

broadened somewhat by proposed section 128.1 contained in draft legislation released by the Minister of Finance on December 21, 1992.

²²⁰ Deeming provisions with respect to the residence of individuals are contained in subsections 250(1) and (2) and with respect to corporations in subsection 250(4).

Neither the de jure nor the de facto control test relies upon the presence of a particular connecting factor. However, generally if either test is satisfied, one or more connecting factors will be present.

De facto control over the trust was the primary test put forward by the Minister in Thibodeau. It is also the main theme of IT-447. In Thibodeau, the Minister argued that the trust should be found resident in Canada because the Canadian resident trustee had sole power under the trust instrument to appoint other trustees, was the principal initiator of investments and made certain decisions without first informing the Bermuda trustees. The Minister also sought to show that most of the trust business during the time was carried on by the Canadian trustee in Canada. The Court appeared to agree that the appropriate test was to determine who was "the guiding mind and will" of the trust.²²¹ However, the Court found (on what may be questionable grounds) that the Minister had admitted that the Canadian trustee did not control the trust assets by assessing the trust on the basis that it had a minority interest in the corporation in question.²²² The criteria selected by the Court as determinative of the issue was that the majority of the trustees were resident in Bermuda and the trust document permitted a majority decision on matters within the discretion of the trustees. The implication is that the Court found that de jure control over the trust property was located in Bermuda.

²²¹ Supra, footnote 135 at page 6386.

²²² This point is discussed in greater detail at pages 60 to 61 above.

The concept of control plays an important role in Canadian income tax. For example, the concept of a Canadian controlled private corporation ("CCPC"), the association rules for corporations and the stop-loss rules all require consideration of the issue of control.²²³ However, control, either de jure or de facto, may not be an appropriate test for determining the residence of a trust for a number of reasons. First, it is important to be able to determine with little difficulty and with some certainty if the trust is resident in the jurisdiction. A test of de jure control may fulfill this requirement. However, it is a rigid test which does not necessarily reflect the reality of the situation. A test of de facto control, on the other hand, focuses on the reality of the situation, but has two major drawbacks. First, it is often not clear who, either as an individual or a group has de facto control at any given time. Second, de facto control is a fluid concept and can easily change or fluctuate. If de facto control were the only test used to determine residence of a trust, that residence could change, with all the attendant consequences, with no other changes being apparent and without outside parties being aware. Other provisions in the Act which prescribe certain consequences of a change of control²²⁴ require a change of de jure control to avoid this problem.

223 For further discussion of the issue of control see Reid, R.J., "Tax Implications of a Change of Control", 1984 Corporate Management Tax Conference, (Toronto: Canadian Tax Foundation, 1984) 84 and Hiseler, G.R., "Corporate Control", Report of the Proceedings of the Fortieth Tax Conference, 1988 Conference Report, (Toronto: Canadian Tax Foundation, 1989) 12:1.

224 For example the "stop-loss" rules contained in subsection 111(5).

Also, the exercise of de facto control in isolation from other factors is not necessarily a logical basis for determining the residence of a trust. Take for example a situation similar to that considered in Dawson. In Dawson the only link to the U.K. was one U.K. resident trustee. The other trustees were non-residents and the trust's assets and administration were located elsewhere. In addition, the trust beneficiaries had long since become resident elsewhere. There was no other link with the U.K. and no rational basis for the application of U.K. tax to the trust's non-U.K. income or property. This would hold true even if the resident trustee exercised de facto control over the other trustees. A more substantial connection with the jurisdiction should be necessary to justify a finding of residence.

Another obvious criticism of either a de jure or de facto control test is that in the case of multiple trustees, all of whom reside in different jurisdictions, control over the trust property may not be exercised in one distinct jurisdiction. As discussed above, arguably for Canadian tax purposes it is necessary only to determine whether or not the trust is resident in Canada. Utilizing the control test as the basis for trust residence, a trust would not be resident in Canada if control of the trust was not exercised in Canada.

It is evident that the control test is an unduly narrow test and easily subject to manipulation. Its application could easily result in a determination of non-residence even though there are other substantial

connections to Canada. Accordingly, the control test in isolation is inadequate and would require the addition of other criteria as well.

Besides the disadvantages set out above, when the tax policy considerations are applied to both the de jure and de facto control tests certain deficiencies become evident. Each test is subject to manipulation much in the same way as the residence of the trustees test. Accordingly, the revenue, horizontal equity and neutrality criteria are not satisfied. However, the enforcement criteria is potentially satisfied to a greater degree than the residence of trustees test, because those who control the trust assets would be accessible to Revenue Canada authorities.

C The Jurisdiction in Which the Trust Property is Administered

The place of the trust administration is the basis of the U.S. test of residence for trusts. It is also a component of the U.K. residence test in relation to capital gains earned by a trust and the Australian test for residence of a trust. This test relies on one particular connecting factor. However, at least one other connecting factor, such as residence of trustees or location of trust assets, is often present as well.

In Thibodeau, the administration of the trust clearly took place in Bermuda. The trust assets and bank accounts were located there and most of the decisions regarding the administration of the trust were made there. In Dawson, similar factors indicated that the trust administration took place in

Switzerland. The trust's bank accounts were located in Switzerland and decisions regarding the trust property were taken at meetings held there. In Jones, the Court had no difficulty in determining that the trust was administered in the U.S. because the trust assets were located there, decisions made and implemented there and the trustees even maintained an office in which the trust business was conducted. It may be recalled that in Jones the trust would have been liable to pay the capital gains tax in question as assessed if it were resident or if it were a non-resident entity which maintained an office or place of business in the U.S. The Court determined that the trust was resident, therefore the latter test was not relevant. However, the case cannot be said to have been decided on the basis that an office was maintained in which to conduct trust business. Such was only one factor which indicated that the trust administration took place in the U.S. making it resident there.

The place of administration usually, but not necessarily, coincides with the residence of a single trustee or with the residence of a majority of the trustees where multiple trustees are involved. Also, the administration of the trust property is usually inextricably linked with the exercise of de facto control over the property. Although such is not necessarily the case. However, the place of administration test focuses on the workings of the trust itself rather than the residence of the trustees. The importance of this distinction is highlighted in the case of a corporate trustee where the trust administration is conducted by a branch in a jurisdiction

different from that where the corporation is resident.²²⁵ The workings of the trust are arguably more relevant to the issue of its residence than where the trustees happen to reside. As pointed out by Mr. Justice Kitto in the Australian Union Fidelity decision,²²⁶ it is unlikely the residence of a trust should depend on something as "fortuitous and arbitrary" as the residence of a trustee. The rules used to determine the residence of a trustee are suited to individuals (or to corporations in the case of a corporate trustee) and are not necessarily suited to a trust.

The place of administration of a trust may not always be as obvious as it was in the Thibodeau, Dawson and Jones cases. The test is admittedly more suited to a corporation which will generally have a place of business or at least a place where the directors meet to make decisions and pass resolutions. However, it should in most cases be possible to determine if any portion of the trust's administration is carried on in a particular jurisdiction and, if it is not, to determine that the trust is not resident there.

The place of administration test would satisfy the ease of enforcement criteria because presumably the trust assets would be accessible. The trust assets would also constitute a substantial connection to the

225 This situation is recognized by Revenue Canada in paragraph 7 of IT-447 which states that in such circumstances the residence of the trust may be "in the jurisdiction where the branch office is located". That this statement has any legal foundation is questionable.

226 The Union Fidelity Trustee Company of Australia Ltd. et al. v. The Commissioner of Taxation, *supra*, footnote 171, at p. 187 C.L.R.

jurisdiction. In addition, it is usually the case that one or more trustees resides in the jurisdiction in which the administration takes place and such would also constitute a substantial connection. However, the place of administration is subject to easy manipulation. Therefore the revenue, horizontal equity and neutrality criteria would not be satisfied by application of this test alone. It would be simple enough to render the trust non-resident by placing the administration outside Canada even though there were Canadian resident beneficiaries or a Canadian resident trustee.

D. Where the Trust Property is Located

The first issue which arises with respect to this test is how to determine where the property is located. If real property is involved the location is obvious. However, the location of personal property is often not so obvious. The location of cash and other tangible personal property may be determined by physical presence. However, the physical presence of share certificates is probably not an adequate basis on which to determine the location of shares. Instead, a preferable test is probably the situs of the shares for conflicts of law purposes. The situs of shares for conflicts purposes is generally the place of incorporation of the company.²²⁷

An obvious criticism of the "location of trust property" test is that it is subject to easy manipulation. It also has no regard for the presence of

²²⁷ See Dicey and Morris on the Conflict of Laws, Vol. 2 (11th ed., 1987) p. 911 and Castel, Canadian Conflict of Laws, Butterworths (Toronto, 1977) p. 349.

other connecting factors. It therefore does not satisfy the revenue, horizontal equity and neutrality criteria. Also, if the only connection to Canada is the location of the assets then enforcement is a potential problem. Execution could be taken against the trust property in Canada for unpaid taxes on the trust's worldwide income, but this may well be insufficient if significant income is earned outside of Canada.

Another criticism of this test is that it would be difficult to apply if the trust property were scattered all over the world. If only a relatively small portion of the trust property were located in Canada, this would obviously be an insufficient basis for Canadian residence. A more appropriate test may be that the trust would be resident in Canada only if a significant portion of the trust property were located in Canada. This significant portion should probably be based on the value of the trust property. However, this would mean that the residence of the trust would be subject to change if the value of the Canadian property fluctuated or if significant additional assets were acquired outside Canada. Therefore there would be a change of residence with the attendant consequences on a relatively arbitrary basis.

Finally, sufficient rules are already contained in Division D of the ITA to ensure Canadian tax is paid when the only connecting factor to Canada is the ownership of Canadian property. Therefore it is not necessary to define residence by reference to the location of assets alone.

E. Summary

None of the tests examined so far are able to entirely satisfy the tax policy criteria. All of the tests fail in varying degrees to satisfy the revenue, horizontal equity and neutrality criteria. The reason for this appears to be that the tests fail to take into account more than two connecting factors (in fact most take into account only one connecting factor) and they are subject to manipulation so that it is possible to render a trust non-resident even though there are substantial connecting factors such as a resident settlor/testator or beneficiary.

The test which is least satisfying based on these criteria is the location of assets test. It fails to satisfy the enforcement criteria and, assuming it is based on the proportionate value of the trust property located in the jurisdiction, it is a relatively unstable basis for residence.

The most satisfying test is the place of administration test. While it has the same deficiencies in regard to the revenue, horizontal equity and neutrality criteria as the residence of the trustees and control of the trust property tests, it at least focuses on the trust itself rather than the trustee and dependence upon rules more suited to individuals and corporations is avoided. The place of administration test is, however, deficient on its own. The question is, in order to achieve some measure of revenue protection, horizontal equity and neutrality, is an entirely different, much more stringent

test of residence required or is it possible to supplement the place of administration test in order to achieve the desired effect?

V. THE OPTIMAL TEST OF TRUST RESIDENCE

A. Features of the Optimal Test

The optimal test of trust residence will focus on the trust as the taxable entity rather than the trustees. It will satisfy all or most of the goals of horizontal equity, neutrality and ease of enforcement while maximizing revenue and will not be subject to inadvertent change. The optimal test of trust residence will be dependent upon the most important connecting factors which have been identified as the location of the trustees and the location of the trust administration. These connecting factors are the building blocks of the various tests of residence, but the optimal test of residence will not necessarily depend upon the presence of one particular connecting factor.

All of the tests of residence examined above are deficient in that they do not satisfy the tax policy goals of horizontal equity and neutrality. All of the tests are subject to manipulation such that it would be possible to create a trust which is not resident in Canada and not subject to Canadian tax on its accumulating income despite connections to Canada in the form of either a Canadian resident settlor/testator or Canadian resident beneficiaries. While the provisions of Division D of the ITA will ensure that Canadian source income will be subject to Canadian tax, foreign source income could

conceivably accumulate indefinitely. While the residence of the settlor/testator and beneficiaries are generally considered weak connecting factors because in isolation they bear little relation to the ongoing operation of the trust, they are important factors in the realization of the horizontal equity and neutrality tax policy goals.

The result is a direct conflict between the tax policy goals of horizontal equity and neutrality and that of efficiency and ease of enforcement. Resolution of such a conflict invariably involves compromise. It may be resolved by expanding the test of residence so as to include reference to the residence of the settlor/testator or of the beneficiaries. This would subject such a trust to Canadian tax on its worldwide income despite a tenuous connection to Canada. It would almost certainly result as well in international double taxation with the resulting application of either a treaty or the rules contained in section 126 dealing with credits for foreign tax paid. In situations where the settlor/testator or beneficiaries were the only connection to Canada, enforcement of Canadian tax liability against the trust itself would be most difficult, if not impossible.

Leaving aside the problems with enforcement, if an expanded definition of trust residence is adopted it may reasonably be questioned why the application of treaties and section 126 of the ITA would not be an adequate means of dealing with the resulting international double taxation.

The problem lies mainly with relying on the application of the various tax treaties into which Canada has entered with other taxing jurisdictions. As pointed out in a recent article,²²⁸ most of Canada's tax treaties fail to deal adequately with determining the residence of a trust. The first step in applying the provisions of a tax treaty in a given situation is to establish residence of the subject in either one or the other signatory jurisdictions. Generally, the process is to first apply either the definition of residence contained in the treaty or the jurisdiction's domestic law with respect to residence. Then, if application of the definition or domestic law results in residence in both jurisdictions, the treaty will often provide tie-breaker rules. Finally, if dual residence still results after application of the tie-breaker rules, if any, the last resort is generally the Competent Authority provisions contained in the treaty.²²⁹ Reliance on the Competent Authority provisions is generally considered unsatisfactory and impractical because of the length and expense of the process and its uncertainty.

Most of Canada's tax treaties do not expressly deal with the residence of a trust. In the case of a treaty which refers the issue of residence to Canadian domestic law, or where the application of the Income Tax

228 Kroft, E.G. "Jurisdiction to Tax - An Update" 1993 Corp. Management Tax Conference Report (Toronto: Canadian Tax Foundation) Tab 1.

229 For more details with respect to the competent authority concept see Mavor, C.W., "Competent Authority: A Canadian View", (1976) 24 Can. Tax J. 484; McGowan, J.G., "Competent Authority: An American View", (1976) 24 Can. Tax J. 486 and Calderwood, J.A., "The Competent Authority Function: A Perspective from Revenue Canada", Report of the Proceedings of the Forty-First Tax Conference, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990) 39:1.

Conventions Interpretation Act²³⁰ requires reference to domestic law, a trust would be lumped in with individuals for treaty purposes because subsection 104(2) of the ITA deems a trust to be an individual for the purposes of the ITA.

Assuming the application of domestic law results in dual residence, resort must be made next to the applicable tie-breaker rules. However, the tie-breaker rules for individuals are inappropriate generally for trusts as they make reference to "permanent home", "habitual abode" and "citizenship". These are concepts appropriate for human beings, not for trusts.

Article 4(3) of the OECD Model Income Tax Convention 1977 (and the 1992 version) provides a tie-breaker rule for persons "other than an individual". The provision is as follows,

Article 4

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

The Commentary on Article 4 makes it clear, however, that the tie-breaker rule contained in paragraph (3) is intended to apply to corporations. This is evident from the use of the term "effective management" which is often

²³⁰ R.S.C. 1985, c. I-4.

associated with the determination of corporate residence. The term is not generally associated with the determination of trust residence.

Even if the provisions were intended to serve as a tie-breaker rule for trusts it would not be particularly effective for Canadian purposes because the vast majority of Canada's tax treaties do not incorporate such a provision, but instead refer the matter to the Competent Authorities. Therefore in most situations where the determination of the residence of a trust cannot be resolved by application of the relevant domestic law, resort must be made to the Competent Authority provisions with all the resultant problems.²³¹

In those situations where by application of a broad Canadian definition of trust residence there is dual residence in Canada and in a jurisdiction with which Canada has not entered into a tax treaty, the resulting double taxation will be dealt with by the application of the provisions contained in section 126 of the ITA. The provisions of section 126 are designed to give credit for foreign tax paid, with the result that the total amount of tax paid is equal to the Canadian tax rate. Most jurisdictions with which Canada has not entered into a tax treaty are low or no tax jurisdictions. Therefore the application of the provisions of section 126 would have little impact on the amount of Canadian tax owing. If a very broad definition of

²³¹ Canada's tax treaties with both the United States and United Kingdom have a provision specifically dealing with the dual residence of trusts or estates. However, both provide for resolution of the matter by the Competent Authorities mechanism.

trust residence were adopted there would conceivably be many instances where there was a large Canadian tax bill, but only tenuous connections to Canada and little or no means of enforcing the tax liability.

It is reasonable to conclude, therefore, that adoption of a very broad domestic definition of trust residence would result in considerable problems in resolving the resulting international double taxation. While it might be desirable to change all of Canada's tax treaties to include a definition of trust residence or enact draconian enforcement provisions, a more reasonable solution may be to rely on a more restrictive definition of trust residence in Canadian domestic law.

In contrast to expanding the definition of trust residence, the use of provisions such as section 94 to resolve the conflict between the tax policy goals appears a much more reasonable compromise. Section 94 applies only if there are Canadian beneficiaries and a Canadian resident who has contributed property directly or indirectly to the trust. In this regard, section 94 goes beyond the connecting factor of the residence of the settlor/testator. Section 94 applies only to Canadian source income or passive foreign source income accumulated by a non-resident trust and, while Canadian residents are jointly and severally liable for the non-resident trust tax liability, such liability is enforceable only to the extent distributions are paid or payable to Canadian residents or an amount is received by a Canadian resident upon the disposition of an interest in the trust.

Section 94 therefore effectively casts the Canadian taxation net around income accumulating offshore where there are significant connections to Canada and eliminates to a great extent any advantage of accumulating funds offshore. In terms of the tax policy considerations identified above, section 94 satisfies, in varying degrees, all four tax policy considerations.

The first tax policy consideration is that trusts with sufficient connections to Canada should be subject to Canadian tax. The connecting factors upon which section 94 depends are the residence of the beneficiaries plus the residence of the settlor/testator. Section 94 actually expands this latter connecting factor by extending it to a Canadian resident who has contributed property to the trust. While these connecting factors on their own are tenuous connections to Canada, in combination and in the context of a provision such as section 94, they arguably form a sufficient connection to Canada to satisfy this tax policy goal.

The second tax policy consideration is that trusts with certain common features i.e., sufficient Canadian connections, should be subject to similar amounts of Canadian tax. Again, satisfaction of this goal is dependant upon the connecting factors of the residence of the beneficiaries and residence of the settlor/testator being substantial enough to warrant the imposition of Canadian tax. For reasons similar to those set out above, it is arguable that this goal is satisfied.

The third tax policy consideration is discouraging the avoidance or deferral of Canadian tax by transferring capital out of Canada and permitting income to accumulate offshore. It is this tax policy goal that all of the tests of residence examined above fail to satisfy because each was too easily subject to manipulation. This is also the tax policy goal that section 94 satisfies most completely and is essentially the justification for the existence of a provision such as section 94.

The fourth tax policy consideration is that there should be no Canadian tax liability unless there are assets in Canada, foreign source income flowing to Canadians or control exercised over foreign source assets or income by Canadians. Although section 94 deems non-resident trusts in certain situations to be resident in Canada and therefore liable for Canadian tax, this tax policy goal is satisfied to a certain extent in that the tax liability is not enforced against Canadian residents except to the extent that they receive income or such income is payable to them.

B. The Optimal Test

For the reasons set out above, the most satisfactory tests of trust residence are the place where control of the trust assets is exercised and the place of administration of the trust. These places are often, but not necessarily, the same. Both tests in isolation are deficient. The optimal test would most likely rely on a combination of the features of both tests.

Accordingly, the optimal test of trust residence in Canada is proposed to be as follows. A trust should be considered resident in Canada if:

- (1) de jure control over the trust assets is exercised in Canada; or
- (2) the place of administration of the trust is located in Canada.

De jure control over the trust assets will generally be exercised in Canada if a sole trustee is resident in Canada or a majority of the trustees is resident in Canada. However, such is not necessarily the case. The de jure control test is preferable to a test which focuses only on the residence of the trustees in that it focuses on the taxable entity which is the trust and requires an examination of the terms of the trust to determine how control over the trust assets may be exercised. De jure control is preferable to a de facto control test in that it is more certain and not subject to inadvertent change.

The de jure control test in isolation is deficient, first because it is subject to manipulation. Second, it does not resolve the issue of trust residence where multiple trustees in different jurisdictions must make decisions unanimously or where trustees must make decisions on a majority basis and a majority does not reside in one jurisdiction. Accordingly, other requirements must be included in the optimal test to ensure that residence will result where substantial connections with Canada exist. This would be accomplished by including the place of administration test in the test of trust residence.

The place of administration of the trust would generally be equated with de facto control over the trust assets. Therefore, if this test were adopted, a trust would be resident in Canada if either de jure or de facto control over the trust property is exercised in Canada. The place of administration also generally coincides with the location of the bulk of the trust assets and often, but not necessarily, coincides with the residence of a single trustee or with the residence of a majority of the trustees where multiple trustees are involved.

Generally, where either the de jure control test or the place of administration test is satisfied, several connecting factors, such as residence of one or more trustees, location of the trust administration and/or location of the trust assets, will be present in Canada. The optimal test described above therefore relies on the connecting factors outlined above, but is not dependent upon a single connecting factor.

The primary advantage of the proposed optimal test is that it focuses on the control and administration of the trust itself. The test does not rely on the residence of the trustee or majority of trustees nor the assumption that a single trustee or majority of trustees has control over the trust property. By focusing on de jure control, it is possible that application of the proposed optimal test would result in Canadian residence for a trust where the only connection to Canada was a Canadian resident protector. It is conceivable that

a protector with power to remove and appoint trustees would be viewed as having ultimate de jure control of the trust.²³²

However, rather than viewing this as a defect requiring alteration of the proposed optimal test, it is suggested that the test should remain as proposed. If it is desired to create a non-resident trust with a protector, it is easy enough to ensure that the protector is not a Canadian resident.

In terms of satisfying the tax policy considerations set out above, the proposed test of trust residence satisfies to the greatest extent the enforcement criteria. This is because either those in control of the trust assets and/or the trust assets themselves would be accessible to Canadian authorities.

The proposed test is less successful in satisfying the revenue, horizontal equity and neutrality criteria, although the test is more likely to satisfy these criteria than would each component of the test in isolation. As set out above, however, no viable test of trust residence will accomplish entirely the goals of horizontal equity and neutrality. A reasonable solution is to instead rely on a provision such as section 94 to satisfy those criteria.

²³² See Donald Applicators Ltd. v. M.N.R. 71 D.T.C. 5202 (S.C.C.) where a shareholder, though lacking immediate voting power to elect directors, had ultimate legal power to change the state of affairs and reserve to itself the power to elect a majority of the directors. The Supreme Court of Canada agreed with the finding of the trial judge that such a shareholder had de jure control of the corporation.

In summary, the proposed optimal test satisfies all the criteria identified above as important in defining the residence of a trust. The proposed optimal test focuses on the trust itself as the taxable entity, rather than the trustees. Satisfaction of the proposed optimal test will require the presence of one or more connecting factors in Canada. Therefore the test is based on connecting factors, although it is not dependent upon one particular connecting factor. The proposed optimal test is not defined too broadly so as to result in inappropriate occasions of dual residence. Nor is it, particularly when used in combination with a provision such as section 94, defined too narrowly so as to permit tax revenue to be inappropriately diverted from Canada. Finally, the proposed optimal test, when used in conjunction with section 94 or its equivalent, satisfies all the tax policy criteria identified as relevant to trusts.

C. Application of the Proposed Optimal Test to the Facts of Thibodeau

As a final exercise and as a final test of the proposed optimal test, it may be useful to apply the test to the facts of Thibodeau.²³³ In brief, the facts in Thibodeau were as follows. A trust was settled by a Canadian resident in 1968 with two Canadian trustees. Immediately thereafter the trust acquired a minority interest in Canadian resident corporations. In 1970 one trustee resigned and was replaced by two trustees resident in Bermuda. Thereafter

²³³ Supra, footnote 135.

there were three trustees; one resident in Canada and two resident in Bermuda. Also at that time, the trust assets and its administration were moved to Bermuda. The trust deed permitted the trustees to act on decisions made by a majority of them. The sole Canadian trustee had the power to appoint replacement trustees. However, it is not clear that he had the power to remove trustees and appoint replacements.

Upon application of the proposed optimal test to these facts, it is clear that the test would not be satisfied on the basis of location of trust administration. It also appears that if the trustees could act on a majority decision and only one of three trustees resided in Canada, de jure control over the trust assets would not be exercised in Canada. However, an argument that de jure control resided in Canada could possibly be made out if the Canadian resident trustee did indeed have not only the power to appoint replacement trustees, but the power to remove trustees as well. In the context of corporations, de jure control lies where the ultimate power to elect a majority of directors is located. By analogy, a trustee (or other person for that matter) with the ultimate power to determine the trustees at any given time may well exercise de jure control over the trust property.

Even if as a result of application of the proposed optimal test the Thibodeau trust was determined to not be resident in Canada, section 94 could have possible application. If there were Canadian residents with a beneficial interest in the trust and the original settlor was a Canadian

resident, the Thibodeau trust would likely be subject to section 94 and unable to escape Canadian tax liability completely.

5. CONCLUSION

The basis for taxation of a person in Canada is residence. A person resident in Canada during a taxation year is liable for income tax on his or her world income. Consequently, the determination of residence is of utmost importance.

In the case of individuals there is a fairly well developed body of statutory and judicial rules which provides adequate guidelines. Similarly, in the case of corporations, an extensive body of statutory and judicial rules exists.

However, with respect to trusts the concept of residence is not so easily applied. A trust is not a legal entity, but instead an equitable obligation. Also, a trust involves several elements, namely the settlor, the trustee, the beneficiary and the trust property itself. Moreover, there can be more than one of each element, one entity can fulfill more than one role and certain elements may be corporations or other trusts. These features make it difficult to apply the concept of residence to a trust.

The ITA does not define the residence of a trust. However, it does specify that a reference to a trust shall be read as a reference to the trustee having ownership or control of the trust property. This has led to the commonly held view that the residence of a trust is to be determined by the residence of its trustees. However, this rule is not helpful in situations where

there are multiple trustees in different jurisdictions. This situation has been considered only once in Canada, in Thibodeau Family Trust v. The Queen. Unfortunately, the decision is remarkably unhelpful in terms of providing guidelines. The situation is also addressed by Revenue Canada in IT-447 which sets out Revenue Canada's opinions. However these opinions lack any legal foundation.

Since it is clear that Canadian statutes, case law and even the administrative pronouncements of Revenue Canada do not adequately answer the question of how to determine the residence of a trust, examination of how the problem was resolved, if at all, in other common law jurisdictions, namely the United Kingdom, Australia and the United States, may prove beneficial. The various tests of trust residence utilized in Canada, the U.K., Australia and the U.S. and those recommended by the Carter Commission all fall within one of four general categories, although some jurisdictions use a combination of tests. These four general categories are:

- (1) residence of the trustees, whether actual or deemed;
- (2) where control of the trust is exercised;
- (3) where the trust property is administered; and
- (4) where the trust property is located.

The manner in which these general categories of tests are utilized differs among the various jurisdictions. In some jurisdictions, emphasis is placed heavily on the trustees who are regarded as the taxable entity. In other jurisdictions, the taxable entity is clearly the trust.

Analysis of the various tests of residence in order to determine which is most satisfactory requires first, determination of who or what is the taxable entity and second, establishment of the standards against which the tests of residence are to be measured.

With respect to trusts, the appropriate taxable entity is the trust itself, rather than the trustees. This then permits the analysis of the residence of a trust to be undertaken in terms of the various connecting factors which connect a trust to a particular jurisdiction.

The analysis of various connecting factors in order to determine jurisdiction to tax was the approach adopted by the Supreme Court of Canada in Williams v. The Queen. The Court outlined a two-step process which first involves identifying the possible connecting factors and then determining the weight to be given to each factor in light of the purpose of the legislative scheme. Accordingly, it is not sufficient to simply identify the various connecting factors which are relevant to the residence of a trust, but also to analyze them in terms of the various tax policy considerations which are relevant to the residence of trusts.

The relevant general tax policy goals include the production of revenue, equity, neutrality and ease of compliance and enforcement. With respect to their application to trusts, the foregoing tax policy considerations may be summarized as follows:

- (a) trusts with sufficient connections to Canada should be subject to Canadian tax;
- (b) trusts with certain common features i.e., sufficient Canadian connections, should be subject to similar amounts of Canadian tax;
- (c) the avoidance or deferral of Canadian tax by transferring capital out of Canada and permitting income to accumulate offshore should be discouraged; and
- (d) there should be no Canadian tax liability unless there are assets in Canada, foreign source income flowing to Canadians or control exercised over foreign source income or assets by Canadians.

All of the tests of trust residence utilized in Canada, the U.K., Australia and the U.S. and recommended by the Carter Commission rely, in varying degrees, on the connecting factors identified as being relevant to the residence of trust. However, none of the tests are able to entirely satisfy the tax policy criteria established as relevant. The primary reason for this failure

appears to be that the tests fail to take into account more than two connecting factors (in fact most take into account only one connecting factor) and they are all subject to manipulation so that it is possible to render a trust non-resident even though there are substantial connecting factors to the jurisdiction. Analysis of the various tests and their respective failings permits, however, the determination of a new test which is more satisfactory.

The optimal test of trust residence will focus on the trust as the taxable entity rather than the trustees. It will not be subject to inadvertent change and will be dependent upon the most important connecting factors which have been identified as the location of the trustees and the location of the trust administration. However, the optimal test of residence will not necessarily depend upon the presence of one particular connecting factor. The optimal test of residence will satisfy all or most of the tax policy goals of revenue production, horizontal equity, neutrality and ease of enforcement to the extent possible.

There is a direct conflict between the tax policy goals of horizontal equity and neutrality and that of efficiency and ease of enforcement. This is because the tax policy goals of horizontal equity and neutrality require certain trusts to be subject to Canadian tax even though the connecting factors linking the trust to Canada are weak. Satisfaction of the tax policy goal of efficiency and ease of enforcement required stronger links to Canada, such as the presence of trust assets or those who are in control of the trust assets. This conflict may be resolved in one of two ways. One resolution

would be to expand the definition of trust residence. However, the result would be a greatly increased incidence of international double taxation for which Canada's network of tax treaties is ill prepared.

The second solution is to base the test for trust residence on the strongest connecting factors, but also have a provision similar to section 94 of the ITA which results in Canadian tax liability where certain non-resident trusts have sufficient connections to Canada.

The optimal test of trustee residence will, therefore, be designed to operate in conjunction with a provision similar to section 94. It is proposed that a trust be considered resident in Canada if:

- (a) de jure control over the trust assets is exercised in Canada; or
- (b) the place of administration of the trust is located in Canada.

It is submitted that this test has all the features of the optimal test. The proposed test focuses on the control and administration of the trust itself, rather than focusing on the residence of the trustee or the majority of trustees. The proposed test utilizes one or more of those connecting factors identified as most relevant to the residence of a trust. The proposed test does not define residence too broadly so as to result in inappropriate occasions of dual residence. Nor is the proposed test, particularly when used in combination with provisions such as section 94, defined too narrowly so as to

permit tax revenue to be diverted from Canada. Finally, the proposed test, when used in conjunction with section 94 or its equivalent, satisfies all of the tax policy criteria identified as relevant to trusts.

It is submitted that the proposed test of trust residence could easily be adopted through legislative amendment. The most appropriate place in the ITA for insertion of the proposed test would be in section 250 which already contains legislative definitions of the residence of individuals and of corporations.

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